Issues and Alternatives 1977

Ontario Economic Council

Intergovernmental Relations

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Ontario Economic Council

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Preface

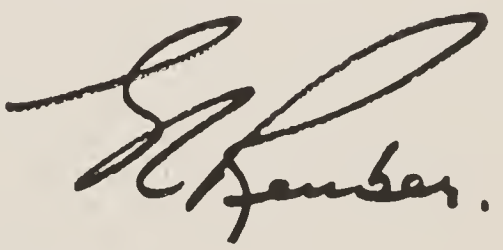
A year ago, the Ontario Economic Council issued a series of papers on "Issues and Alternatives" in six areas of major concern for public policy in Ontario and in Canada. These papers focussed on public expenditure policies in the fields of health, housing, education and social security, as well as on policies related to national independence and the development of northern Ontario.

As a direct extension of its work in these areas, the Council is now issuing three additional papers under the general heading of "Issues and Alternatives". These concentrate on the outlook for the Ontario economy during the next decade, the public decision-making process and intergovernmental relations. The purpose of these papers, as of those published earlier, is to highlight major issues, as we see them, to stimulate informed public debate on these issues and to provide a framework for discussion about possible improvements in government policies.

In the Council's view, this paper addresses the single most important issue facing Ontario and Canada at present – the issue of arriving at satisfactory and broadly-accepted relationships among various levels of government in this country. The report consists of two parts. The first presents a general statement by the Council on this subject: the second part consists of ten papers on particular aspects prepared by persons who have specialized knowledge in these areas. Although these papers were commissioned by the Council and we believe warrant publication, it should be clearly recognized that the papers reflect the views of the authors and not necessarily those of the Ontario Economic Council.

It is the Council's hope that this report will help to illuminate this all-important subject and that discussion of the problems the paper raises and the approaches it suggests will assist in resolving some of the highly complex and sensitive issues in question.

While each member of the Ontario Economic Council does not necessarily subscribe to everything contained in the introduction to this report, the report does reflect a consensus of the members.



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Toronto, Ontario

Mr. Reuben C. Baetz
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University of Toronto

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Head
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Queen's University

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Mr. John J. Stuart
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J. T. Wing Limited

†Mr. William F. Wilder
Chairman
Canadian Arctic Gas Study Limited

††Dr. David M. Winch
Chairman
Department of Economics
McMaster University

††Chairman of the Ad Hoc Committee on Intergovernmental Relations
†Members of the Ad Hoc Committee on Intergovernmental Relations

Introduction

There are significant differences among the regions that comprise Canada: in per capita income, culture, tastes, resources, climate, terrain, population density and industrial mix, to name only a few. But there are similarities and common interests too. A common currency, a common market that allows the free flow of goods, labour and capital, a common transportation system, a common defence force and other communalities: all can be presumed to improve our collective material standard of living. Canada's existence as a nation is based, however, not only on these material advantages. A shared love of Canada and shared pride in its accomplishments also play a major role in making Canada a nation.

What is obvious when stated but nevertheless often forgotten is that the basic rationale of a federal system of government such as we have is based on the proposition that powers and responsibilities should be allocated between the federal government and the provinces so as to capture the special advantages that each level of government can provide. Thus, those activities that can best be done collectively at the centre should be carried out by the federal government. Other activities should be within the jurisdiction of the provinces in order to allow as much diversity as possible among the provinces in fields where the kinds of differences described above are significant and the decisions made by one province are unlikely to have significant effects on the well-being of the residents of other provinces ("spillover effects").

In short, if Canada were a homogeneous plain populated by individuals

with identical tastes and preferences distributed evenly, Canada would not need a federal form of government. A unitary form would be entirely appropriate and the geographic divisions would be solely for administrative convenience. It is our geographic and other diversities that not only explain but justify a federal form. It is our common interests and our common feelings that not only explain but justify a confederation rather than ten (or more) separate, distinct and sovereign governments.

It is essential to recognize that any federal system of government which inherently constitutes a compromise between regional and collective interests is not without its costs. Intergovernmental tensions are endemic and some degree of intergovernmental duplication is unavoidable. The task is to maximize the benefits of the federation at minimum cost, through adoption of the appropriate division of powers and responsibilities, taking into account the factors mentioned above.

Another important consideration should be kept at the forefront, particularly in the light of recent developments in Quebec. Sometimes the residents of a particular province (region) may *perceive* both that they have distinctive differences from the residents of other provinces and that they constitute a minority within the country. If the majority were persistently to vote for national policies and programs that the minority rejected, a coercion of the minority by the majority would be *perceived.* A demand for secession of the province encompassing most of the minority would hardly be surprising. If such coercion were expected to persist, its residents would conclude that they had more to gain than lose from separation.

In order to focus attention on some of the critical issues concerning intergovernmental relations in Canada, the Ontario Economic Council decided to commission a number of papers from knowledgeable individuals. Not all issues are covered: obviously too, the members of the Council have differing degrees of support for the various points of view expressed. But the members of the Council do believe that the arguments set forth in the papers should be considered carefully by informed Canadians. It is in this spirit that these papers are being presented. A brief synopsis precedes each of them. The balance of this introduction does little more than put these papers in some perspective.

Canada has two official languages. But far too often this is a legal proposition rather than a reality of life. Too few of the residents of Ontario are functionally bilingual. The Council believes that most children in Ontario (and in other provinces too) should and could be bilingual at an early age. Bilingualism should be looked upon as an opportunity rather than as a punishment. We have an opportunity to widen the horizons of our children through French language training. Surely to see more is better than to see

less! But the language issue is only one of many when one considers intergovernmental relations.

It is often forgotten that under the present governmental system each Canadian is represented by at least three governments: federal, provincial and local. When these governments negotiate with one another the citizen is put in the position where, in a sense, he indirectly negotiates with himself. Each level of government acts as though it had a mandate to push the interests of its constituents with little regard for the fact that, to some degree, each has the same constituents. The operative words are, however, "to some degree". Many interests are not common.

Governments can be thought of as a means of simultaneously serving common interests and of reconciling conflicting interests in a way that legitimizes the outcomes, so that those who lose are willing to acquiesce in their losses. Political leadership can be thought of as an attempt to persuade the electorate of the communality of their interests and thereby to reduce the degree of intergroup conflict.

As indicated above, the division of powers and responsibilities among the three levels of government is an attempt to assign public functions in such a way as to allow the greatest freedom of choice at the local level while avoiding "beggar-my-neighbour" decisions. The benefits of the collective provision of those public services where there are significant economies of scale in production need to be preserved. Every effort should be made to minimize barriers to the mobility of goods, capital and people so as not to serve the short-run interests of the few at the expense of the long-run interest of the many. As one of the appended papers indicates there has been an unfortunate trend in the opposite direction.

Another important issue is the redistribution of income among regions and provinces. The position taken in this country in the past has been that when the residents of a "poor" province pay the same tax rates as do the residents of a "rich" province, both should obtain the same per capita revenue.[1]

The foregoing objectives, particularly when conceived of in the light of the basic roles of any government and of the role of leadership in particular, necessarily imply perpetual tension in a federation.

The constant demand for more cooperation among the provinces and between the provinces and the federal government should be recognized as

[1] This proposition implies the principle that residents of different provinces should be equally affluent with respect to expenditure on public goods, while they are markedly unequal with respect to expenditures on private goods. This can introduce a distortion into the allocation of resources between the private and public sectors. To the extent that such a distortion occurs it presumably could be justified in terms of the need for a common minimum standard of public services in order to unify the country. One conceivable alternative approach which might avoid this distortion, but might also create other difficulties, would be to reduce disparities in individual personal incomes on a consistent basis across the country.

rhetoric that can strengthen the tenuous bonds that hold us together. This is not to denigrate the need for these symbolic statements but to recognize that the resolution of conflict is also part of the reality. Tension is inherent when interests are divergent.

Perhaps if we stopped deluding ourselves that there is a "right" solution to this conflict we could better live with, and start to adjust to, the permanent tension among interest groups that is a necessary part, but not the whole, of federal-provincial relations.

Let us consider some specific points.

The Government of Ontario has taken some responsibility for stabilization policy. That is to say, it has assumed some responsibility for reducing high unemployment and high rates of inflation. The evidence does not suggest that the Province of Ontario acting alone can accomplish a great deal with respect to economic stabilization. But the Province is in the position of having to demonstrate concern, even though its hands are shackled, if not tied. For a Premier to say that he was powerless to tackle a painful, pressing issue that burdened the voters in his province clearly would be unacceptable. Most voters are unaware of the constitutional niceties. But there are, in fact, constitutional niceties! In particular, no province has control over the money supply. This makes provincial borrowing much more difficult. Ontario has large fixed commitments, in particular Hydro. The Province is stuck with sources of revenue that grow less rapidly than Federal revenues grow. And as another of the Council's policy papers shows, some of the moneys borrowed from the Canada Pension Plan in the past will have to be repaid in the future.

This will make it increasingly difficult for the Province to make a significant contribution to short-run stabilization by lowering taxes unless the rate of growth of expenditures can be held down dramatically. Perhaps its greatest contribution to the resolution of the stabilization problem would be to introduce structural changes over which it has jurisdiction that would help us overcome in the years ahead the central difficulty facing the economy: high unemployment rates combined with high rates of increase in the price level.

Among the structural changes to be considered in this context are the following: reduction in the inordinate economic power of special interest groups, by increasing competition and reducing regulation; reduction of the propensity for government expenditures to grow, by redesigning the social welfare and income support system to change the incentives implicit in these systems and to improve their efficiency; increasing the incentives for private investment; pricing publicly-provided goods and services on an economic basis; improving industrial relations generally and the arrangements for arriving at satisfactory wage and salary settlements in the public sector in particular; and introducing changes in the educational system to help create a better match of people and jobs. In the absence of such structural changes economic stabilization is more difficult because the price increases imposed

or induced often have to be "validated" by the federal government through increases in the money supply if unemployment in other sectors is to be avoided. The inflationary dangers are clear.

Higher energy costs are a serious problem for this Province. The argument that other provinces well endowed with oil, gas and coal should now have their "innings" because Ontario has benefitted from the tariff in the past is largely specious. Most of the prevailing tariffs were imposed many decades ago. There seems little doubt that, at least with respect to natural resources, they were largely capitalized at the time, bestowing some large capital gains on a few financiers and industrialists resident in Ontario and inflicting capital losses on other Canadians (e.g., the value of Prairie land was probably reduced by the so-called "National Policy"). There is little possibility of rectifying any distributional inequities that occurred at that time. Surely this century-old inequity – if such it was – does not justify penalizing the progeny of those who gained – not to mention the hundreds and thousands of new arrivals to Canada.

This is not to say that the prices of energy and other resources should not be allowed to rise. Higher prices will help to ration efficiently what is scarce and to enlarge its supply. The question is rather who should expropriate the windfall gains (rents) generated by the rise in world prices? If the world price of uranium were to rise astronomically how should the bonanza be shared: shareholders, miners, processors, the provinces (largely Ontario) – the people of Canada generally? Clearly, there can be no decisive answer to this question. It can be argued that some split would be desirable and the whole gain should not be appropriated by any one of the groups mentioned above. Nor should the tug-of-war between the provinces and the Government of Canada be allowed to squeeze out the shareholders to the point where further investment is endangered. Perhaps the answer is some formula, agreed upon in advance, that would apportion among the contending parties the windfall gains (or losses) arising from long term changes in the world prices of the products of Canada's natural resources.

In some ways so-called equalization payments raise the same issues. The federal government obtains funds by taxing Canadian individuals and businesses and then makes unconditional grants to the poorer provinces so that their residents do not have to pay higher provincial taxes in order to obtain the same quantity and quality of public services as the residents of the richer provinces.

The Council strongly supports some form of equalization payments. In a sense they are a basic ingredient in the glue that binds Canada together, however precariously. Indeed, the Council would prefer to see an enrichment of the equalization system if this could be offset by reduction in the hidden equalization implicit in some other federal programs, such as Regional Economic Expansion and some aspects of Unemployment Insurance. This

would serve to make it clearer what is actually going on in terms of inter-provincial transfers and, more importantly, would increase provincial autonomy – a much desired goal at this time.

Such changes would be consistent with the federal government's recent decision to transfer tax points and to make unconditional grants to the provinces in lieu of the 50-50 split of the costs of a number of major shared-cost programs. This was a major step forward, in the Council's view.

The Council believes that the federal government should act in accordance with the proposed Victoria agreement and should not again use its "spending powers" under the constitution unilaterally to enter fields of provincial jurisdiction. These invasions of provincial jurisdiction in the past were rationalized on the ground that all Canadians were entitled to a common minimum standard of health and higher education. With an adequate equalization scheme and more tax room for the provinces this argument is unpersuasive. The residents of provinces *did* elect their provincial governments. Presumably their priorities should prevail over matters within provincial jurisdiction.

The issue of the patriation of the "the Constitution" cannot be ignored. There is obviously symbolic appeal to patriating "the Constitution" – the heart of which is the British North America Act – a statute of the government at Westminster. It is incongruous that some crucial relationships among federal, provincial and local governments are greatly affected, if not solely determined, by a statute of what is, in every real way, a foreign (but friendly) power. But it should be remembered that the constitution is more than the BNA Act. It also encompasses many court decisions and traditional practices.

While not wishing to denigrate the symbolic importance of patriation, the Council wishes to emphasize that "the Constitution", broadly conceived, has served Canadians well. It has been remarkably flexible. Power has shifted to the centre in times of war. It has shifted, and continues to shift, to the provinces and local governments in times of peace. Perhaps too slowly and certainly painfully, shifts have occurred, as the statistics on the relative shares of federal, provincial and local government expenditures attest.

Nevertheless we have some problems. Leaving aside the symbolic question just discussed, we have the problem of an overly secretive federal-provincial negotiating process; civil rights are not included in the BNA Act; agreement cannot be reached on an amending formula; the federal government unilaterally makes Supreme Court appointments – the individuals who would ultimately decide what our patriated constitution was (or is!).

There are no easy answers. Recognition of the fact that the tension is inevitable is perhaps the beginning of wisdom. There will always be intergovernmental tension. Intergovernmental rivalry is, in many ways, the source of our individual freedom.

Where does this Council stand with respect to these extremely important and difficult issues?

It believes that the Government of Ontario should resist any effort by the federal government to patriate the BNA Act unilaterally. This would make the provinces in some sense creatures of the federal government rather than partners with it. The Council also believes that Ontario should continue to press for the "Victoria" amending formula or some formula similar to it. The rule of provincial unanimity with respect to constitutional changes cannot be justified given the wide divergence in population sizes. The Council also takes the view that the Government of Ontario should continue its efforts to work directly with other provinces to create an effective system for the expression of local priorities in relation to the federal government.

Let us turn briefly to some of the issues in provincial-local government relations.

There are both striking differences and similarities between federal-provincial relations on the one hand and provincial-local relations on the other. The over-riding difference is, of course, that the power and responsibilities of the provinces are derived from the constitution: local governments, as creatures of the province, obtain their powers and responsibilities by provincial government delegation. Legally, if not politically, what has been given can be taken away. Provinces rarely if ever delegate unconditionally all of their powers or responsibilities in any field. They usually retain the right of review or approval or impose conditions or control of purse strings with respect to their transfers to the municipalities.

There are, however, some important similarities between the two relationships. Which functions should be carried out by the province because there is a communality of province-wide interest (or should be!) and which should be delegated to local governments in order to allow diversity of public services, given the diversity of needs and tastes among widely divergent communities? There is the problem of spillover effects – and in particular the avoidance of "beggar-my-neighbour" policies. There is the problem of fiscal responsibility – requiring local governments to bear the political costs of raising at least some share of the revenues for the goods and services the municipality provides to its electorate. There is, as at the federal-provincial level, the conflict between putting pressure on local governments through offering to share costs to induce them to change their spending priorities so that common standards are realized across the province. There is also a need for unconditional equalization grants to make it possible for "poor" local governments to provide the same quantity and quality of public services as "rich" local governments if they levy the same tax rates.

In recent years there appears to have been an attempt by the federal government to by-pass provincial governments and deal directly with local governments on such issues as local transit and low-cost housing. This has

further complicated intergovernmental relations.

One aspect of provincial-local relations that has no counterpart in federal-provincial relations (except in the Northwest Territories and Yukon) is the optimal geographic size of local governments – the regional government question. This is because the political boundaries of local governments can be unilaterally determined by the provinces. Provincial boundaries cannot be altered unilaterally by the federal government.

Just as there have been massive increases in federal transfers of funds to the provinces so has Ontario greatly increased its transfers to local governments, partly to induce local actions consistent with province-wide priorities, partly for equalization reasons and partly to take the pressure off the property tax. While the property tax is probably more maligned than it should be, the Council approves of these increases in transfer payments to local governments. However, the Council urges that the mix of conditional and unconditional grants be gradually altered towards greater reliance on the latter. The imposition of central priorities, centrally-imposed inducements and central controls that over-ride differences in local needs, priorities and conditions is as seductive to politicians at Queen's Park as to those on Parliament Hill!

Because it has undertaken no studies about the implications of regional government and because the Robarts report on the government of Metropolitan Toronto is in the offing, the Council does not feel it would be sensible to comment on the regional government question here. It would like to point out, however, that some or all of the "savings" that are frequently advanced as a reason for the merger of local governments are often offset, in whole or in part, because a "levelling up" effect seems to be almost inevitable. That is to say, if several municipalities have different quantities and qualities of police and fire protection, garbage collection, and so on, the standards prevailing in the municipality with the highest standard with respect to a particular service usually becomes the common standard of the merged group of local governments. The same is true of the wages and salaries of the merged municipalities. The highest becomes the floor for the totality. This is costly!

As a guiding principle in provincial-local government relations, the Council espouses the same principle as it advocates with respect to federal-provincial relations: as much decentralization as possible to reflect differences among communities while maintaining at the centre only those powers and responsibilities in which there is a common interest, coupled with the maintenance of fiscal responsibility by forcing local taxpayers to see in their tax bills direct reflection of most of their level of consumption of locally-provided public goods and services.

Current Constitutional Issues

Richard Simeon

This paper begins with a summary of the history of attempts to agree on a formula to patriate the Canadian constitution. The author goes on to discuss some possible criteria for judging proposals for constitutional change. The paper suggests amendments in the procedures of constitutional review and concludes with a discussion of some of the issues raised by the Quebec election.

Since 1927, Canadian governments have sought a way to patriate the British North America Act and to discover a formula to govern its amendment. Since 1968 these issues have been joined with broader proposals for more substantial change in Canada's most important constitutional document. Now, in the wake of the November 15 Quebec election, the country faces in sharper terms than ever before the most fundamental constitutional question of all: whether it will continue to exist as a federation and, if so, under what terms.

In June 1971, agreement on an important, if limited, package of constitutional reforms, embodied in the so-called Victoria Charter, seemed imminent. But it foundered on the rock of Quebec's desire for more profound changes in the Canadian federal system. In 1976, the debate was rejoined when the Prime Minister proposed discussion of the more limited issue of patriation and suggested that, if the eleven governments could not agree, then the federal government might arrange patriation unilaterally. But

once again, it was found that patriation could not be discussed in isolation from the other central issues of amendment and jurisdictional change.

The discussion was carried forward by the provincial premiers meeting without federal participation. Considerable progress apparently was made and by the fall of 1976 federal-provincial discussion was to resume. But the Quebec election rendered much of this discussion obsolete. We must now reconsider all constitutional options, in the widest possible framework.

Many commentators have questioned the value and feasibility of constitutional reassessment and revision. Two grounds for this opposition have been advanced. First, despite the lack of an amendment formula, the large number of constitutional grey areas, and the obsolescence of many of the provisions drawn up in 1867, the British North America Act has proved to be a flexible, adaptable constitutional document which has served Canadian needs well. It has accommodated the swings of the pendulum between provincial and federal power, has permitted development of extensive co-operation between governments, and has allowed Canadians to pursue some of their most important collective goals. Perhaps it would be better, some believe, to let this evolutionary process continue rather than to rewrite the constitution from scratch, especially as it would begin to be obsolete the day after it was signed.

The second objection to basic constitutional change is more practical: it can be argued that in the absence of agreement among Canadians about the very structure and purpose of their polity, agreement on constitutional alterations would be unattainable, and could exacerbate the underlying conflict. Conceivably the more we tried to agree on constitutional fundamentals the more disagreements would be revealed. Recent events seem to bear out this pessimism.

But between 1968 and 1971, the pressure for constitutional review could not be denied. There were many motives: the desire to modernize an "outdated constitution"; to entrench civil and linguistic rights; to rationalize the distribution of powers; and to provide a constitutional statement of the transcendent goals of Canadians. But all these were secondary to the major impulse for change: the commitment of Quebec governments to basic alterations in the structure and operation of the federal system. This pressure led to the review, and remains with us. Most other provinces were generally content with existing arrangements and were prepared to live with the piecemeal process of constitutional adaptation.

This analysis of the constitution examines three broad issues. First is patriation. It is an embarrassing anomaly – one of the last vestiges of our colonial past – that the most important element in the Canadian constitution remains nothing more than an Act of the British Parliament and that amendment of the constitution requires us to petition a foreign government, even if its approval is automatic. While patriation might not have much

practical significance, it would have considerable symbolic importance in reaffirming Canadian nationhood. We have not been able to take this step because it presupposes some agreement on a means to amend the constitution. The long search for such an amendment formula has been unsuccessful.

In principle it is possible to discuss both patriation and amendment separately from questions of substantial change in the actual provisions of the constitution, as did most discussion before 1968. But, first with Quebec, and then with the other provinces, agreement on amendment has become bound up with the search for changes in content: in the distribution of powers, the entrenchment of language and human rights, the role of the federal spending power, and so on. Thus the three sets of issues are intimately related. We cannot agree on patriation because we cannot agree on amendment; increasingly, we cannot agree on amendment because we cannot agree on substance. In his 1975 initiative, Prime Minister Trudeau tried to break this log-jam but with little success. Let us look at each of these issues in turn.

Patriation

Compared with inflation, unemployment, or the energy crisis, few would consider patriation a burning issue. Canada has survived for more than 100 years without obvious inconvenience. Nevertheless, it is the only federation in the world which lacks the formal authority to amend its own constitution.

If patriation is obviously such a worthwhile objective, why have we failed, despite discussions going back at least to 1927, when Canada was negotiating the Statute of Westminster (1931), by which Britain relinquished its jurisdiction over the Dominions? The issue arose again in 1936 and 1950, still without progress. In 1960 the new Progressive Conservative government in Ottawa once more took up the challenge. After several years of discussion, agreement was reached both on a procedure for patriation and on an amendment formula, known as the Fulton-Favreau formula, after the two federal Justice Ministers who had led the discussion. Quebec, after intense opposition within the province, rejected it.

In 1967 a new Quebec government, led by Daniel Johnson, initiated debate on a wide range of major constitutional proposals which would have had the effect of substantially altering Quebec's role in Confederation. While previous Quebec governments felt change could be achieved by piecemeal negotiation on specific issues, the *Union Nationale* argued for explicit constitutional change. The constitutional review between 1968 and 1971 followed, culminating in the Victoria Charter, a package which embodied patriation, a new amendment formula, some alterations in the distribution of powers, entrenchment of limited language and political rights, alterations in the

status of the Supreme Court of Canada, and other matters. Once again, Quebec rejected the Charter not because of the patriation or amendment provisions, but primarily because it believed the jurisdictional changes, especially in responsibility for social policy, had not gone far enough.

After this disappointment, there seemed to be general agreement to abandon further attempts to reach agreement on the constitution. In April 1975, however, the Prime Minister renewed the initiative with a proposal that amendment and patriation be separated from the question of jurisdiction. If agreement on these limited issues could not be reached, then Ottawa might achieve patriation on its own. This was the first time unilateral patriation had been suggested and it presumably represented an attempt to pressure the provinces to agree on a procedure and break the impasse which had developed. Strong opposition to this perceived threat immediately developed, both in Quebec and among the other governments.

In March, 1976, the Prime Minister identified four possible courses of action, ranging from simple patriation, saying nothing about amendments, to a more elaborate agreement in which patriation would be tied to the Victoria Charter amendment formula and to a "Draft Declaration" incorporating many of the changes about which there was now apparently full agreement. This would come into effect only when all the provinces had consented.

The provinces unanimously rejected the proposed federal initiative and embarked on their own attempt to resolve the issue. Patriation, they argued, could not be discussed in isolation from jurisdictional changes. Unilateral patriation would, for the moment anyway, formalize the existing convention which requires provincial unanimity for most important amendments. Since the attraction of "patriation" would no longer exist as an incentive for provinces to agree on an amendment formula, then that matter might be even further postponed, without anything having been resolved, and Canada might be left with a most inflexible amendment procedure. Patriation alone would solve none of our other constitutional problems: it is more logical to see it as the culmination of a constitutional revision than as a prelude.

Constitutional Amendment

Fundamental to any federal constitution is a set of rules which will govern amendment of the constitution, especially those sections which set out the respective rights and responsibilities of the constituent governments. Our inability to agree on such a formula must therefore be considered one of Canada's most important constitutional failures.

No comprehensive formula for amendment was written into the original British North America Act. The framers of the Act did not see themselves as

establishing a wholly independent new government; Canada was in 1867 essentially a colony of Britain. Thus it was natural to vest the amending power in the Imperial Parliament.

But the Act is not totally silent on the matter. Section 92(1) allows the provinces to amend their own constitutions. The Act also stipulates that the Senate and House of Commons can petition the British Parliament for an amendment in a Joint Resolution. Convention suggests no such request would be refused. The question is: what role should the provinces play?

Of the sixteen amendments to the BNA Act which have been enacted, ten have resulted from unilateral federal action. But most dealt only with federal concerns, such as changes in the composition of the Senate and House of Commons. For amendments concerning the division of powers, a convention calling for provincial unanimity has emerged.

The one important exception to this rule was a 1949 amendment inserting Section 91(1), which, over some provincial objection, allowed the federal government unilaterally to amend the Act in all matters except those dealing with provincial jurisdiction, provincial rights and privileges, school and language rights, the terms of the House of Commons and provision for an annual session of Parliament. Thus much of the BNA Act is already patriated. On all other matters – those most important for the operation of the federal system – the convention of unanimity seems unchallenged.

Several alternatives have been presented in the continuing search for an amendment formula. The 1964 Fulton-Favreau formula required provincial unanimity for the most crucial elements of the constitution: provincial legislative powers, the use of English and French, denominational rights in education, and provincial representation in the House of Commons. It required concurrence of Ottawa, together with two-thirds of the provinces representing half the population, for some basic features of the national government, such as the role of the Crown, the five-year limit on the duration of the House of Commons, and provincial representation in the Senate. Flexibility was added by a provision for the delegation of powers from one level of government to another if the affected parties agreed.

After having been approved by all governments, this formula was eventually rejected by the Quebec government led by Jean Lesage. In the past, Quebec had sought a rigid amendment formula, to ensure its jurisdiction would not be invaded by a coalition of the English-speaking provinces and the federal government. It now sought far-reaching changes in the distribution of powers, and felt that a rigid amendment formula might block that development by allowing a single government to veto modifications.

The next major amendment formula formed part of the 1971 Victoria Charter. Its basic proposal was that amendment would require the concurrence of the federal Parliament, together with: each province containing twenty-five per cent of the Canadian population, at least two Atlantic

provinces, and at least two Western provinces with a combined population exceeding fifty per cent of the region.

This general formula would apply to the division of powers, the use of the English and French languages, and to certain institutional characteristics, such as the role of the Crown, the duration of parliaments and legislatures, the powers of the Senate and provincial representation in Parliament. With these exceptions, both the provinces and the federal government would be free to amend their own constitutions. Amendments affecting only some provinces could be made by Ottawa and the provinces concerned. This mechanism remains on the bargaining table.

In departing from absolute unanimity, the Victoria Charter formula would have provided somewhat greater flexibility than did the Fulton-Favreau formula. But, it lacked the Fulton-Favreau procedure for delegation of powers between governments. This formula ensured that Quebec and Ontario would have a veto over any future changes, and put British Columbia in a stronger position than the other seven provinces.

Several objections to the formula have since arisen. Alberta, concerned primarily with the possibility that it would permit a coalition of governments to invade its control over its natural resource wealth, now argues for a more rigid formula. It has proposed that the unanimity rule be retained for matters having to do with "the lands, mines, minerals, royalties or other assets of a province; the powers of a Province to make laws; and, the rights or privileges granted or secured by the Constitution of Canada to the Legislature or the government of a Province". The exact scope of this proposal is unclear, but it seems substantially to erode the flexibility of the original Victoria Charter proposal and replace it with the unanimity rule. British Columbia has also objected, proposing that it also have a veto, giving it the same status as Ontario and Quebec. Despite these recent provincial views, it seems certain that without Quebec an amendment formula would long since have been adopted. Meeting in Toronto, in October, 1976, eight of the provincial Premiers argued for acceptance of the Victoria amendment formula, while British Columbia and Alberta did not. The difference was not resolved.

In contrast to the arguments for greater rigidity to protect provincial rights, is the argument for greater flexibility, to limit the ability of minorities or of a few provinces to frustrate the will of the majority. The former Minister of National Defence, James Richardson, has recently argued this case. No province, he suggests, should be permitted a veto over amendments. Rather, amendments should be adopted either by the approval of provinces representing 60 per cent of the population, or by a national referendum in which a simple majority rule would apply. Canadians, he argues, must not be restricted for all time by a 'single province' veto. This view of Canada as a set of individuals, in which the majority interest should prevail, conflicts with the view of the country as a grouping of provincial communities, each with

rights to be protected. In the existing framework for debate on constitutional issues it seems certain that a proposal such as Richardson's would not be accepted.

Why have Canadians not been able to agree on an amendment formula? In part, it may simply be because of lack of urgency. After all, we do have some form of amending procedure, embodied in Sections 92(1) and 92(2), together with the convention of unanimity on substantial change. Moreover, many devices have made for considerable flexibility, through which the federal system has been greatly modified, without benefit of formal amendment in the BNA Act. Judicial review has had a great impact on the meaning of the constitution. The federal "declaratory power" has allowed it to take responsibility for such new policy areas as atomic energy. The virtually unlimited federal spending power provided the vehicle for a massive federal role in building the welfare state, both through grants to individuals, and through shared-cost programs with the provinces. The machinery of federal-provincial consultation, nowhere mentioned in the British North America Act, but now an essential part of our "operating constitution" has also been an important means of change. But more fundamentally, we cannot agree on amendment because we lack a national consensus on the respective roles of federal and provincial governments.

It is difficult to recommend an amendment formula. From the point of view of the individual citizen it is virtually impossible to predict what the actual policy consequences of one or other alternative are likely to be. Would a veto for every province mean that at some time in the future the will of a large majority of citizens would be frustrated? Would a more flexible procedure mean that at some time the same majority would impose its views against the strongly held wishes of a minority group?

On the other hand it is essential not only that the amendment procedures safeguard the interests of the provinces generally vis-à-vis the federal government, but also that the interests of the residents of particular provinces be protected, especially on those matters about which they feel most strongly. Hence a relatively rigid formula seems most appropriate. Formal constitutional amendment in that case would be relatively rare, and occur only when there was a very strong consensus. Short of that, the necessary continuous modification of the federal system would be carried on through the less rigid and more adaptable process of intergovernmental negotiation.

Substance: the Issues in Constitutional Change

Once the decision to undertake a comprehensive review of the constitution was made in 1968, the stage was set for a wide-ranging debate about the inadequacy of the existing document and about possible substantive changes

in it. For Quebec, the issue from the outset was the distribution of powers: the rights of governments to tax and spend, and the allocation of responsibilities between them. The federal government was reluctant to enter this potential minefield. The debates between 1968 and 1971, however, did include considerable discussion of the division of powers in such areas as social security and the use of the federal spending power, with little progress.

Ottawa resisted any major transfer of powers and some provinces agreed. The only major substantive change in the 1971 Charter, which summed up the results of three years work, was to give paramountcy to the provinces over family, youth and occupational training allowances, under a revised Section 94A. In addition, the Charter provided for a limited set of political rights, entrenchment of certain language rights, though with limited application in several provinces; some role for provincial participation in the selection of Supreme Court Justices, with a guarantee that at least three judges be appointed from the Quebec Bar; a general commitment to promote equality and reduce regional disparities; and a commitment to hold a conference of First Ministers at least once a year.

Four years of constitutional negotiations had thus produced little agreement on substantive change. In response to the Prime Minister's suggestion for renewed discussions of patriation and amendment, the provinces once again returned to matters of substance in 1976.

These issues constitute the current agenda for constitutional change. Inevitably it reflects not only long-term constitutional options, but also the immediate concerns of the governments for their own policy priorities, and for their present conflicts with Ottawa. Thus, Quebec had stressed its desire for greater jurisdiction in social policy during the Victoria Conferences: its more recent position on culture and communications reflected Premier Bourassa's stress on "cultural sovereignty". Similarly, Alberta's concern with energy was reflected in some of its proposals in 1976.

What are these current issues? In the fall of 1976, Peter Loughheed of Alberta, chairman of the provincial meetings, reported unanimous provincial agreement on the need for a concurrent provincial role in immigration; for strengthening the jurisdiction of provincial governments over ownership and taxation of lands, mines, minerals and forests; for limitation of the powers of the federal government to declare a particular work for the general advantage of Canada, unless the provinces affected concurred; for confirmation of the language rights set forth in the Victoria Charter; for mandatory annual meetings of First Ministers; and for making creation of new provinces subject to the same formula as amendments.

It was also proposed that a new section be added to the constitution making "arts, literature and cultural heritage" a concurrent power with provincial paramountcy. The provincial role in selection of Supreme Court justices and of the Chief Justice was to be expanded. Greater provincial

power was sought in communications. More important, the general federal spending power was to be limited by requiring explicit provincial approval before it could be exercised to achieve federal purposes. It would also be possible for a province to "opt-out" of joint programs. Given the central role the spending power has played in the expansion of federal activity into areas of provincial responsibility, this is a most crucial proposal, placing a tight constraint on federal power.

Thus the provinces have proposed a considerable widening of the scope of constitutional discussion. Moreoever, as they have also done in the financial field, they have held wide-ranging discussions without federal participation, and have reached considerable agreement among themselves. Taken together these proposals imply a large extension of provincial jurisdiction and powerful limitations on the ability of the federal government to intervene in areas of provincial responsibility. The movement from 1968 to the present thus demonstrates a strong assertion of provincial rights, in which the governments of many provinces adopted constitutional positions which only Quebec was taking a few years ago.

It is not possible to examine here the advantages and disadvantages of each of these possibilities, or to recommend specific constitutional provisions. Nor is it possible to predict the effects of the many alternatives on the general ability of the three levels of government jointly to fulfil the needs of Canadians.

Some Criteria for Judgement

It is possible to suggest some broad general criteria against which some of the proposals, and others which may be made, could be judged.

One obvious criterion is efficiency. A constitution should divide the responsibilities of government so as to achieve a balance between the responsibilities falling to each level and the resources available to meet them. It should increase accountability and minimize decision-costs by allocating functions unambiguously, avoiding duplication and overlapping. But federal systems are unlikely ever to give much satisfaction to the efficiency expert. No once-and-for-all delineation of responsibilities can ever respond to the ever-changing roles of government, or to the emergence of new policy issues, which are seldom respecters of constitutional lines. "Watertight compartments" will inevitably leak. Thus, while rationalization of government responsibilities should be an important consideration, it cannot be the primary one. It was not the desire for more efficient government which prompted the present dissatisfaction with the constitution; nor would greater efficiency end it.

A second criterion is symbolic. The constitution should inspire and educate. It should symbolize the commitment to unity, and spell out the loftiest goals of the community. From this point of view, the present BNA Act is sadly lacking: instead of ringing affirmations of Canadian nationhood, it is written in prosaic workaday language. In a country with so few unifying symbols, a good case can be made for a more inspiring constitution. But that flies in the face of Canadian realities. Agreement may be possible on specific provisions, but a search for appropriate language in a preamble setting out the "objectives of the federation", "the purpose of Canadians in having become and resolving to remain associated together in a single country", and "what kind of country Canadians want, what values they cherish, and what objectives they seek" as proposed by the federal government, is likely to become hopelessly bogged down (Government of Canada, 1969, 4-6). A constitution may reflect a consensus, but no constitutional language will create one where it does not yet exist.

Third, the fundamental characteristic of federalism is a constantly shifting balance between two sets of goals that are often complementary but which are also often in conflict. On the one hand there is a search for national community and national institutions capable of dealing effectively with common problems and achieving common purposes: this is the goal of nation-building. On the other hand is the desire to promote regional diversity, to permit locally defined communities to grow and pursue their own purposes: this is the goal of province-building. The difficulty we face in achieving an amendment formula or redesigning our constitution reflects this tension. It suggests the need to rethink carefully the purposes of the national government, and to decide what powers and responsibilities it needs if it is to fulfil its role. The same must be done at the provincial level.

In addition, because citizens' orientations and aspirations, and the problems that face them, can shift from time to time, it is also essential that the constitutional mechanisms be flexible enough to reflect these changes, allowing the federation to move from relative centralization to relative decentralization, and back again, without major constitutional dislocation and without the constitution acting as a barrier to responsive government. Because what the national government does will inevitably affect province-building, and vice-versa, it is essential that the constitution embody mechanisms for consultation, mutual influence, joint decision-making and the accommodation of conflicting interests between governments. National interests in a decentralized federation cannot be met by the national government acting alone; they must also be met by the provinces acting collectively. At the moment the provincial current is running strongly; one of the central difficulties of constitutional review is that rather than trying to formalize a stable situation, we are trying to pin down a very fluid one. It is hard to hit such a moving target.

Procedure for Constitutional Review

Constitutional review has now been a central concern of Canadian political debate for almost ten years. It is useful to ask, therefore, how the debate has been carried out, and whether the procedures should be modified.

The central characteristic of this debate is that it has been intergovernmental; the participants have been restricted almost entirely to the leaders of the federal and ten provincial governments. Few legislatures have been involved in the discussion. A Special Joint Committee of the Senate and House of Commons was appointed in 1972. It held public meetings and produced a useful report, but otherwise played little role. Canada's other level of government – the municipal – also sought representation but without success. The Confederation of Tomorrow Conference and several of the later Constitutional Conferences were televised, and this contributed an important element of public education – but otherwise public involvement in the process was limited. Participation and public awareness in the most recent round of discussion have been even more restricted.

This limitation of the constitutional debate to the executives of the eleven governments has some important consequences. Most important it focusses discussion on a narrow range of issues; those which are of primary concern to governments as institutions. From one point of view governments are, of course, representative of the views of their electorate; but, from another point of view, like all organizations, they have their own preoccupations with their growth, status, security and administrative convenience. Much intergovernmental conflict in Canada revolves around such questions. The issues are not so much what should be done, but rather of jurisdiction, responsibility and power. These preoccupations have been evident in much of the debate on the constitution. It has focussed largely on the intergovernmental problems of federalism itself, and the alternatives considered have been those thought most feasible by the governmental participants.

Other issues, which may be just as important in any broader conception of revising the Canadian constitution, do not get a hearing. For example, the place of local government in our constitutional framework has not been discussed. Nor has the role of Parliament and legislatures, despite their widely noted decline in status in recent years. Nor have we looked at the electoral system or at a variety of other means of increasing the responsiveness of federal political institutions to regional interests. For example, the list of political rights set forth in the Victoria Charter is immediately followed by this sharp limitation:

> Nothing in this part shall be construed as preventing such limitations on the exercise of the fundamental freedoms as are reasonably justified in a democratic society in the interests of public safety, order,

> health or morals, of national security, or of the rights and freedoms of others, whether imposed by the Parliament of Canada or the Legislature of a Province.

It is also significant that both the Fulton-Favreau and Victoria amendment formulae include only the eleven governments as parties to the process. Australian, Swiss and American amendment procedures all provide a role for the electorate. It is evident that the range of issues considered, and the alternatives brought to bear, have been substantially constrained by the restricted nature of the participants.

While it is inconceivable that the role of governmental executives in constitutional review could be significantly altered, or that constitutional change could occur without agreement by provincial governments, this is another reason why broader involvement by informed citizen groups, by political parties, and by MPPs and MPs could widen the range of alternatives considered. While that might, in one sense, make agreement on change even more difficult to attain, it might also attenuate somewhat the sharp intergovernmental competition which now makes agreement so difficult.

While it is unlikely that the governments would agree to any fundamental alteration in the procedures for constitutional review, the Ontario government could take steps to encourage wider familiarity with and discussion of the matters now under discussion. This could take the form of establishment of a committee of the Legislature, similar in purpose to the federal Special Joint Committee established in 1970, which would provide a forum both for a full canvassing of opinion in the Legislature and for participation of citizens in open hearings. The reestablished Ontario Advisory Commission on Confederation can also serve as a useful sounding board for government proposals. This wider discussion and analysis is rendered more vital now than ever before by the results of the Quebec election.

The Future of Constitutional Review

By early 1977, the future of constitutional review was unclear. The election of the *Parti Québecois* government dramatically changed the terms of the debate, since its goal of independence would represent a far more fundamental restructuring of the federation than any proposal made so far. This development left the recent discussion on patriation and amendment which we have described in something of a limbo. Three possible courses of action are now possible.

The first is to move quickly to patriation with an amendment formula similar to that proposed at Victoria, and perhaps with a few other limited alterations. In January 1977, the Prime Minister suggested to the provinces a

renewed attempt to do so, but without any threat to patriate unilaterally. This would not, of course, deal with the basic issue; but it could demonstrate a minimal degree of unity, and clear the constitutional decks for later debate about the federal structure. It would only be possible if the other provinces were temporarily to abandon the arguments for substantive changes in the division of powers which they had made in 1976. The desire to demonstrate a commitment to national unity might well create such an incentive. This procedure would also require Quebec to remain aloof, saying that it is not really concerned with these minor revisions, and is willing to let the other governments agree among themselves. For this reason, of course, little would be achieved by this strategy even if it were to succeed.

The second alternative is to place a moratorium on constitutional discussions for the time being, on the grounds that there are at present too many uncertainties on all sides. Neither the federal nor the other provincial governments have yet thought through their position. On the other hand, the outcome of the internal debate within Quebec remains unclear. Given these uncertainties, the prospects for success of major constitutional negotiations would be limited. Moreover, their failure could only strengthen the likelihood of Quebec's seeking independence.

The third strategy suggests, as Prime Minister Trudeau has recently indicated his willingness to do, that constitutional negotiations, starting essentially from scratch, with every aspect of federalism up for debate, could begin quite soon. This would take us back to 1968, but in very different circumstances. In that process, it might be possible to explore the range of modifications to the federal system which might be acceptable to English-Canadians and their governments in various regions, and which might satisfy the aspirations of Quebecers for greater autonomy. But if such a wholesale review of all constitutional options were to take place, independence would also have to be on the agenda. An optimistic view is that substantial accommodation could be reached, with the prospect that the danger of disintegration of the federal system would be averted; but the pitfalls would be numerous.

It is indeed vital that wide-ranging discussion of all possibilities take place, and it is also clear that negotiations between Quebec and other governments on a host of current issues will have implications for future constitutional decisions. But to place this dialogue at the level of formal Constitutional Conferences at this time is clearly premature. If the process between 1968 and 1971 failed, then the probability of failure in the new situation is much greater. Instead, the future of Confederation will be better served by wide-ranging but less structured debate both within and between the federal and provincial governments, and by citizens. That informal process may then later serve as a basis for more formal proposals in the future.

In the short run, three broad alternatives present themselves, though

they are not mutually exclusive. First is a continuation and extension of the present federal strategy, which might be described as a combination of measures to enhance the status of French language and culture in the country as a whole, through measures for official bilingualism, strengthening of French-Canadian representation in Ottawa both at the political and official levels, and general measures to alleviate regional disparities. The difficulty is that in English Canada there has been a substantial erosion of support for the bilingualism programs and in French Canada these programs do not appear to have stemmed the rising desire for independence. While such strategies should not be abandoned – indeed, to do so would guarantee separation – they are equally clearly not enough, and it will be increasingly difficult for the central government to fight the pressure coming from both sides. It is important, however, for Ontario, along with the other provinces, to maintain its support for both equalization and the official bilingualism programs.

It also can be argued that there is a need for a massive decentralization of powers not just to Quebec, but to all the provinces. This could convince the residents of Quebec, Alberta and other provinces with strong regional grievances that their own governments have the powers they need. There are indeed many possibilities for alliances between the new Quebec government and the other provinces on particular issues. Such a strategy is attractive from many points of view. But it remains uncertain how much decentralization alone could satisfy the clear desire of many Quebecers not only for concrete powers but also for the symbolic benefits of independent nationhood. Certainly devolution of responsibility for culture, immigration and a few other matters is not likely to be sufficient. On the other side, we must ask whether English-Canadians would accept the diminution of federal powers that large-scale decentralization would entail. It is possible that at some point federalists would say, "If the price of keeping Quebec in is that much decentralization, we would prefer a formal break".

A third strategy is to reconsider the somewhat discredited concept of "special status", by which it would be recognized that Quebec is not a province like the others, and that it should have powers and responsibilities distinct from them. To some extent, of course, this is already the case: Quebec operates its own contributory pension plan, while a federal plan operates elsewhere.

The present Prime Minister came to Ottawa specifically to do battle with this option and fought a successful election campaign partly in opposition to it. The concept itself is vague and ill-defined: many different degrees of special status can be envisioned, some not looking very different from the program of the *Parti Québecois* itself. Many important objections to the idea can be raised, such as the status of Members of Parliament from Quebec when legislating on matters in which Quebec was autonomous. There is also

the possibility that special status would lead to a slippery slope, achieving separation by degrees. It is also questionable whether special status would meet the objectives of Quebec, and whether the leaders of English-Canadian provinces would agree.

Nevertheless, in light of recent developments, this option too must be given careful consideration. We must consider new alternatives. We cannot proceed on the constitutional review, or any other federal-provincial matters, as if nothing has changed or as if the new government in Quebec is nothing more than just another government, with no objectives beyond a little more provincial power.

In this debate, Ontario will play a crucial role. Its positions will have a significant effect on English-Canadian opinion; and it will be an important voice at the bargaining table. Hence both the government and citizens must carefully think through the available options in the light of the criteria outlined above. All the constitutional debate so far is just prologue to the issues now before us; yet perhaps it is also true that there is a certain inevitability – that the debate started so many years ago would result in our being forced to ask whether French and English can indeed live under the same constitution much longer.

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The Federal-Provincial Decision Making Process

Richard Simeon

This paper examines the existing processes and formal machinery of federal-provincial and interprovincial coordination. It discusses some of the problems that have arisen and suggests some possible alternative types of machinery. The author emphasizes, however, that fundamental conflicts will inevitably remain.

Two central facts characterize the relationship between federal and provincial governments. The first is that they are *interdependent:* functions and responsibilities are not neatly divided between Ottawa and the provinces. In virtually every important policy field one finds two and often three levels of government deeply involved. Social policy, environmental policy, economic policy, and many others are all shared: effective policy requires joint action. What one government does will affect the ability of others to achieve their goals. Watertight compartments of sharply defined responsibilities no longer exist, if, indeed, they ever did. The second fact is that governments are in some policy fields *autonomous:* none can dictate to the others. Each has extensive resources – political, constitutional, and financial – with which to pursue its own goals and influence others. Hence, in order to achieve coordination and collectively deal with the problems facing Canadians, governments must find ways to resolve conflicts, coordinate their activities, and jointly make policy. An elaborate framework of intergovernmental bargaining and negotiation (which has been described variously as

"cooperative federalism", "executive federalism", "administrative federalism" and "federal-provincial diplomacy") has therefore arisen. It has become one of the most important processes, if not the most important process, within which policy is developed in Canada.

This paper will examine the nature and extent of the collaboration and sharing between governments, describe the structure and operation of the machinery for coordination which has developed, assess some of the problems and criticisms which have developed, and consider some alternative means of rationalizing the processes of federal-provincial decision-making.

Shared Responsibilities

In few policy areas – except perhaps defence, the post office or garbage collection – does one government act alone. Social welfare policy, for example, encompasses purely federal programs (family allowances, old age pensions, unemployment insurance); shared cost programs (the Canada Assistance Plan); purely provincial activities; and often municipal financing and administration of welfare. The amount, cost and quality of housing available to Canadians is affected by local zoning and building standards, provincial land use policies, grants to home buyers, landlord-tenant regulations and a host of other measures; and federal policies such as sales taxes, interest rates, use of federally controlled lands, and the programs of Central Mortgage and Housing Corporation with respect to public housing, neighbourhood renewal, and the availability of mortage funds. A similar pattern repeats itself over and over again.

Why has this pattern developed? The first reason is constitutional. The framers of the British North America Act could not anticipate the new responsibilities – such as the welfare state or environmental quality – that government would undertake in the twentieth century. Hence, as old functions changed in importance and as new functions arose, they did not neatly fit into the constitutional categories set out in Sections 91 and 92 of the Act. The number of constitutional grey areas, and of effective concurrent jurisdiction, multiplied. Moreover, as matters within provincial jurisdiction became more salient, imbalances between assigned responsibilities and available resources grew. Under the twin impact of the Depression and wartime centralization, the federal government, with the general support of the provinces, moved strongly into areas of provincial jurisdiction. In part this was achieved by a transfer of jurisdiction but much more commonly it involved the federal government's use of its unrestricted spending power in order to develop new transfer programs to individuals and to influence provincial policies through the device of shared-cost programs. As new policy concerns arose, both levels of government found that they possessed the

constitutional powers to become involved. New issues almost inevitably cut across jurisdictional lines, making a comprehensive attack on them difficult. Policy tends to be a seamless web: political institutions are sharply divided within and between governments.

Two more specific factors also account for the sharing of responsibilities. First, citizens make demands on governments with little understanding of constitutional divisions: both levels of government are under pressure on consumer issues, women's rights, the environment and so on. Both therefore try to respond. This is linked to the phenomenon of bureaucratic expansionism. Governments – and individual agencies within them – seek to move into those policy areas in which they perceive political credit to be gained. The federal government established a Ministry of State for Urban Affairs; provinces became involved in manpower training; both established consumer protection bureaus.

Frequently governments compete for primacy, especially in new problem areas. In the immediate postwar period, the federal government was most expansionist: its bureaucracy had vastly grown in size and competence during the war; it had centralized the tax system; Keynesian economics gave a new rationale and new tools for economic management; and public opinion seemed receptive to the welfare state and a more dominant central government. The result was massive federal intervention into many areas of provincial jurisdiction under the rubric of "cooperative federalism". More recently, the growth in importance of provincial matters, the increasing size and competence of provincial governments, the inability of the federal government adequately to reflect regional diversity and other factors have contributed to more expansionist provincial governments. They have sought not only fewer federal controls and more taxing powers but also a greater voice in economic, transportation, trade and other policies over which Ottawa has primary jurisdiction. This may be seen as a shift from federal dominance to the "attenuation of federal power". But it can also be seen as an expansion of the roles of both levels, with a resulting increase in overlapping and joint responsibilities.

A list of joint federal-provincial programs in 1975 included almost 300 different programs (Federal-Provincial Relations Office, 1975). And, in addition to these programs, both levels were simultaneously involved in many other policy areas. At some times there have been explicit attempts at coordination. At others, the two levels of government have operated independently of each other.

The growth in shared responsibilities – together with much increased provincial shares of spending and revenues in recent years – poses many questions.

The most general problem has been called "entanglement" by the Ontario Government. Entanglement takes several forms. Some programs

simply *duplicate* each other: for example, Ontario's Home Ownership Made Easy Plan and Ottawa's Assisted Home Ownership Plan. Both provide cash grants to first-time home buyers. Similarly, both levels pursue active programs for economic development, often in competition. Some programs are *fragmented* between two levels. Ontario's Guaranteed Annual Income Supplement is added on top of the Federal Old Age Security Program. Provincial welfare systems come into play when Unemployment Insurance benefits run out. A change in one affects the other. *Incursion* occurs when a government makes a policy which affects the existing programs provided by the other level. Recent federal competition policies, for example, may well run up against provincial regulation of the legal profession, or of realtors. *Spillovers* occur when one government in its attempt to deal with a problem, creates new burdens for the other level. For example, the proposed federal Young Offenders Bill may create additional administrative and financial difficulties for the administration of justice by Ontario. Often governments will seek to *neutralize* the effects of policies by one level which are seen to be harmful to the other. Ottawa altered its corporation tax regulations to counteract the effect of provincial changes in mineral royalties and taxation in 1974, to illustrate the point.

The problems are not merely administrative. There is also more substantial conflict as governments compete with each other both for resources and political support. Given their different perspectives and constituencies, they have different priorities and goals. Intergovernmental relations therefore are a mixture of conflict and collaboration. Disagreements arise both about the substance of policy – what should be done – and jurisdiction – who should have the power to do it.

Finally, underlying much federal-provincial conflict are the considerable regional differences in wealth, economic structure, and ethnic make-up and the like. Conflicts between Ontario and Ottawa are primarily over administrative difficulties, and disagreements over how best to achieve development goals. But in the West, Atlantic Canada and Quebec, these are less important than are sometimes profound differences in basic social and economic goals.

One result of this overlapping and duplication is greatly to increase decision costs. Coordination itself requires a great deal of time and effort and involves the energies of a host of officials serving on a multitude of federal-provincial committees. Decisions are likely to take longer to reach when the interests of many governments must be reconciled.

It is impossible to measure the extent of these costs. But they are high. Related to these decision costs is the danger that, in the preoccupation with competition and coordination, policy discussions turn primarily on questions of organization, financing and jurisdiction; less attention is available for discussion of the substance of the actual policies to be pursued. Programs are likely to be contradictory or inconsistent with each other. Alternatively,

other policy problems may be neglected because they fall between jurisdictional stools.

From the viewpoint of the citizen affected by policy the existing system also has costs. It is often difficult for citizens to know which level of government is responsible for what. Thus it is difficult to know where and how to intervene in the policy process. When governments share responsibility, or one level of government pays for programs administered by another, it is much more difficult to achieve accountability. The citizen does not know whom to praise or to blame. Intergovernmental argument about jurisdiction often seems irrelevant to citizen needs. It is difficult to anticipate what a change, such as ending shared cost programs in the health field, means for the cost and quality of care.

Against these costs of overlapping and duplication, however, must be set some advantages. Given the division of powers in the BNA Act, and the difficulty of amending it, joint action (largely through the device of shared cost programs in welfare, health, and post-secondary education) was essential if the new needs of Canadians were to be met. Despite many difficulties, the welfare state has been firmly set in place through such collaboration. Intergovernmental sharing of responsibility also allows the accommodation and reconciliation of the twin goals of achieving national purposes and responding to regional diversity. It permits variation and experiment in policies across governments.

The Machinery of Intergovernmental Relations

An elaborate machinery of intergovernmental negotiation and decision-making has developed outside the former Canadian constitution. Yet it is now an essential part of the effective constitutional framework. The central element is "executive federalism": a pattern of bargaining between the executives of federal and provincial governments similar in many ways to international negotiations.

The primary institution is the Federal-Provincial Conference or the Conference of First Ministers, at which the Prime Ministers and Premiers, together with large delegations of Ministers and officials, meet to discuss the broad issues of federal-provincial relations. The meetings provide an opportunity to exchange information, exercise mutual influence, and occasionally to make joint decisions. The Conference is not, however, a formal decision-making body. The decisions reached there must be ratified by the individual governments. The agenda varies but tends to focus on the immediate issues of current federal-provincial conflict. Increasingly the atmosphere has been one of confrontation, as provinces have sought to influence federal policies and gain a greater voice in many policy areas. Most conferences involve all eleven

governments. But there has recently been more bilateral diplomacy in which federal representatives travel the country preparing the ground for coming negotiations. The Western Economic Opportunities Conference, called to discuss Western grievances, represented the first recent conference at which Ottawa sat down with a group of provinces.

During the constitutional conferences between 1968 and 1971, a Secretariat was established to provide support services and coordination for the governments. That has been succeeded by the Canadian Intergovernmental Conference Secretariat. Its role is primarily that of administration and housekeeping. Canada has no joint intergovernmental body of officials comparable to the Commission of the European Common Market.

One of the chief objections to these conferences is that they are secret. Several of the constitutional conferences were open to press and television but the normal pattern is for *in camera* discussion. To the extent that the meetings are a forum for detailed negotiation, secrecy is probably justified. But to the extent that they are increasingly a setting for basic debate about the nature of Canadian federalism and broad policy options – with more detailed negotiation going on elsewhere – then this role is more akin to that of Parliament. Openness should be increased.

In the past, provincial governments seldom developed a common position before sitting down with federal representatives. In many cases provincial positions differed. "Ganging-up" was considered not only a violation of the informal rules of the game, but was difficult to achieve. One of the most important recent developments in federal-provincial relations has been an increasing tendency for the provinces to develop joint positions, and to negotiate with each other, without federal participation. Thus regional groupings, such as the Atlantic Premiers and the Prairie Economic Council, have played a greater role. In the renewed constitutional discussions in 1976 the provinces met alone to discuss patriation and other issues. And in the discussions on financial arrangements in 1976 the Premiers went to Ottawa with a common front on many issues. Provinces are thus tending to negotiate their differences among themselves, and present Ottawa with an agreed position. This could greatly increase their bargaining power, making it harder for Ottawa to pursue a policy of divide and rule. Provincial unanimity is likely to be limited, however. Interprovincial differences on many issues – between oil consumers and oil producers, between richer and poorer provinces and between Quebec and other provinces – are likely to remain.

Interprovincial conferences have another purpose as well: to permit provinces to exchange information and coordinate policies which are not immediate issues of federal-provincial debate: for example, the agendas of these conferences, now held annually, have included such matters as interprovincial trucking and securities legislation.

Below the Conferences of First Ministers are meetings of groups of Minis-

ters. Some, such as conferences on housing, are *ad hoc*. Some, such as those established during the Constitutional Conferences, are sub-committees reporting to the First Ministers. Others have been held more regularly. One of the most important is the Conference of Finance Ministers which is not only a forum for discussion of fiscal issues but also for exchange of information and plans concerning general economic policy. The increased fiscal weight of the provinces makes such meetings especially important.

Other, more formal, ministerial meetings include groupings of Ministers in particular areas, such as the Council of Resource Ministers and Council of Ministers of Education, which meet regularly, and have had their own secretariats and research staffs. This whole structure could be formalized and rationalized to cover more systematically the major policy areas.

Finally, there is a host of meetings of officials. Again, some are *ad hoc*, while others meet regularly. The range of such meetings is broad. Some are devoted to coordination of relatively detailed and non-controversial matters: others are devoted to more general issues of policy and strategy, primarily as backup for the more political meetings of ministers and premiers. The most important of these have been the Continuing Committee on Fiscal and Economic Matters and the Continuing Committee on the Constitution.

In general, the more specific the policy areas the more harmonious have been federal-provincial meetings. Often officials concerned with specific program areas, such as welfare, share common professional goals. To some extent they have more in common with each other than with their respective political masters. Recent events, however, have undermined this pattern of harmonious relationships, which developed after World War II, in the heyday of the adoption of many shared cost programs. Federal-provincial discussion is increasingly "political" and devoted to the broad issues of overall governmental strategy. Conflict is less contained at the official level, and more likely to find expression in disagreement among politicians.

There are several reasons for this development. In part it reflects the general increase in regional differences and the desire of provincial governments for more autonomy and power. In part it reflects governmental desire to achieve much greater control over their own patterns of spending and policy priorities. Hence, most governments have now moved to exert greater central coordination, through cabinets, treasury boards and other agencies, over the cooperative activities of program officials. Governments have sought to ensure that official relationships will be subordinate to overall political strategy. Thus Ottawa has established a cabinet committee on federal-provincial relations and the Federal-Provincial Relations Office alongside the Privy Council Office. Quebec was the first province to establish a ministry of Intergovernmental Affairs. Ontario has established strong control through the Department of Treasury, Economics and Intergovernmental Affairs. Alberta has established a ministry of Federal and Intergovernmental Affairs

and other provinces have followed suit.

The development of new techniques for policy analysis and political control within governments has, perhaps ironically, had the effect of sharpening intergovernmental conflict and rendering policy coordination more difficult. One important consequence of these developments is to ensure that political disagreement, especially the competition for status and power, may override concern for the substance of policy. The central actors are Premiers, Treasury Departments and the like. For example, the Canada Pension Plan was discussed by these participants primarily as a problem of intergovernmental finance, not as a problem in social policy. Similarly the recent discussion of the future of shared cost programs in higher education and health care subordinated the discussion of the content of these programs. Financial and jurisdictional concerns were overriding.

Carrying out intergovernmental negotiations is a major preoccupation of Canadian governments. A 1957 study discovered 67 federal-provincial committees. In 1967, 119 such committees were identified. In 1973, representatives of Alberta participated in 118 meetings and conferences: 25 were bilateral, 73 included all governments, and 20 were regional. Twenty-three occurred at the ministerial level, 24 at the level of Deputy Ministers, 14 at the assistant Deputy level, and 14 at other levels (Smiley, 1976.) The decision making process is obviously complex.

In the 1940's and 1960's cooperative federalism was a vehicle for federal leadership. In the 1970's, the same machinery has become the mechanism through which the provinces have become much more important political actors. The bargaining power of the various governments varies greatly from issue to issue and from time to time. Most fundamentally, power depends on the extent of the political support a government enjoys. The growth of regional feeling and the erosion of electoral support for the present federal government in many areas seems to account for increased provincial assertiveness. In addition, the constitutional allocation of responsibilities affects bargaining power. Provinces remain little more than pressure groups in a federal area like transportation or in seeking more generous equalization. Influence also depends on skill and competence. While it is difficult to measure, it appears that the technical and administrative resources of provincial governments have increased greatly in recent years. They are less willing to defer to federal expertise. The mechanisms of federal-provincial negotiations have also played a significant role. Provincial governments now play a major part on the national stage and have come to be seen as integral parts of national policy-making mechanisms. The forum provided by federal-provincial machinery also allows provinces to act together against the federal government.

It should not be thought, however, that power has shifted decisively away from Ottawa. While deferring to the provinces in some areas, the

federal government has been acting more aggressively in others – especially in economic policy and regulation. The heightened conflict stems from the existence of two levels, both of which are innovative, aggressive and self-confident.

This process also suggests that the distinction between national purposes and provincial purposes is not sharp. The federal government can be heavily involved in provincial development. On the other hand, it is possible that national purposes can be attained through federal-provincial negotiation, or even by the provinces acting together without much federal involvement.

The range of issues debated in this federal-provincial forum is wide. A quick summary of the current issues under negotiation will illustrate this point:

– Public finance: equalization, shared cost programs, the revenue guarantee, and tax collection agreements;

– Transportation: conflict over the federal move towards "user pay" as a principle, prairie freight rates, regulation of trucking, the federal worry about provincial ownership of Pacific Western Airlines, the Pickering airport, passenger rail transport;

– The constitution;

– Justice: legal aid and family law reform;

– Immigration: the demand for a greater provincial role;

– Energy: oil and gas pricing, subsidy to the east coast, energy exports, interprovincial transmission of electricity, supply and refining of uranium, integration of federal and provincial coal development strategies, conflicts over pipelines and energy exploration, off-shore minerals, the need for co-operation in energy conservation;

– Other economic matters: closure of armed forces bases, foreign investment, alterations on federal banking policy, securities legislation;

– Native peoples: tribal land claims, provision of social services to Status Indians;

– Parks;

– Communications: the provincial desire for regulatory authority over cable TV and for public ownership of communications networks;

– And so on. . .

The agenda is a long one, and it is always changing.

Assessment of the Process

The mechanisms for intergovernmental consultation can be assessed from various points of view: the federal government might assess them differently from provincial governments and both differently from citizens.

Federal-provincial conferences have been the vehicles for increasing provincial criticism of the federal government. It is sometimes argued that federal policies in such areas as transportation, trade and economic policy do not adequately take account of provincial needs and interests. The provinces have sought greater influence in these areas with mixed success. Provinces have also acted more aggressively on their own on matters such as agricultural marketing, trade, foreign ownership and economic development.

It is also argued that the federal government controls too great a share of the more elastic and lucrative revenue sources. This, it is said, encourages the federal government to move more aggressively into areas of provincial jurisdiction, such as municipal affairs, while starving the provincial public sector. In part this is a purely political argument. The provinces have every right to increase taxes and Ottawa argues quite rightly that they simply wish the federal government to take the blame for raising taxes.

Finally, it is argued that the federal government moves indiscriminately into areas of provincial jurisdiction without adequate consultation. The federal government responds to its own political environment and its own policy goals of which the provinces form only a part. This complaint is frequently justified but it must also be noted that "adequate consultation" is in the eye of the beholder. Frequently the issue is not whether or not there was consultation but rather whether or not Ottawa acceded to provincial requests.

Shared cost programs have become the primary focus of discontent. Provinces complain that such programs have been introduced and terminated without full discussion; the conditions attached to them have been onerous and have increased administrative difficulties; that the lure of 50-cent dollars represented in cost-sharing formulae has skewed provincial priorities. They have also complained that sharing formulae have led to irrationalities. For example, it is claimed the hospital insurance program has encouraged overproduction of acute-care hospital beds but done nothing to increase availability of cheaper extended-care facilities that are badly needed.

Shared cost programs have also been criticized from the federal side. Ottawa was helping to pay for programs for which it got no credit. The fact that Quebec had opted-out of many such programs in 1964 implied a form of special status. But most important, the costs of the most important programs were rising faster than either governmental revenues or GNP. Ottawa has little control over a large part of its own spending budget. With the growing concern with restraining growth in government expenditures, Ottawa first moved to put a limit on year-to-year increases in the most important programs. It then proposed that medicare, hospital insurance and post-secondary education be turned over to the provinces completely, along with a fiscal package including cash payments and further tax shares. The new federal-provincial Fiscal Arrangements Act, negotiated in 1976,

embodies this important policy change. It represents a substantial disengagement of federal and provincial activity. While it does not rule out additional shared-cost programs in the future, it does suggest the device will have only limited use and, indeed, Ottawa itself has suggested its willingness to limit use of the federal spending power to circumstances in which there is prior provincial consensus.

This should reduce some of the problems of overlapping and joint administration, and give the provinces increased freedom to adjust these policies in light of provincial needs. It has some costs, however. It means that the poorer provinces will be even more dependent on the revenue equalization program to alleviate regional disparities and thus will be highly vulnerable to changes in it. It also means that program differences between provinces are likely to increase. The dilemma remains: can policy simultaneously achieve national goals and be responsive to differing provincial needs and priorities?

From the point of view of the public, the process we have described has other consequences. The secrecy and complexity of the negotiations makes public awareness of the issues and alternatives extremely difficult. The arcane technical language with which questions of tax points, shared cost programs, the spending power and others are discussed by governments renders public understanding even harder. Governmental concern with the federal-provincial bargaining game may well lead to policy competition in which citizen groups are caught in the cross-fire: the experience of mineral and petroleum companies in the conflict over mineral revenues is a recent example.

More generally, the process ensures that issues of intergovernmental concern – structural, jurisdictional and financial – will always be to the fore. It increases the Canadian tendency to see policy in regional terms and to force even issues that are not on the surface obviously "regional" – like poverty – into a regional mould. Other definitions of the situation and other policy alternatives tend to be neglected because of the dominance of intergovernmental relations in policy debate. The process does make it difficult to deal with "national" policy problems, because jurisdiction with respect to them is divided.

On the other hand, it could be said that the process is an effective accommodation both to the constitutional rigidities and to the obvious fact of the importance of regional divisions. From this point of view it could be said that the process permits reconciliation of conflicting interests, that it adjusts effectively to the varying strength of provincial and national demands and that without it the problems of policy-making in the federal state would be even more difficult. In a real sense the problems of contemporary Canadian federalism are not so much the problems of the machinery of intergovernmental discussion but are rather the consequences of the sharp

regional conflict in the country, the kinds of policy problems it faces and the inability of any constitution unambiguously to divide responsibilities.

Reforming the System

In considering reform of the mechanisms of intergovernmental relations, two sets of alternatives can be raised. First, what can be done to minimize the overlapping, duplication and inconsistencies which characterize so many areas of public policy in Canada? Second, how can the formal machinery of federal-provincial decision-making be modified so as to promote public awareness, facilitate compromise and increase the capacity of governments jointly to deal with major societal problems?

The first strategy might be called "disentanglement", the search for ways to identify policy or program areas in which both levels of government are operating, in order to identify overlaps. This could be done on an area by area basis. In each, then, the governments should ask to what extent are the activities complementary, competing, redundant, and so on. Once these areas are identified, it may be possible to disengage: to allocate some to each level of government, in which it would be able to act alone.

Such an administrative procedure could usefully rationalize many areas which have grown up on a piecemeal basis without much rational consideration.

It would not, however, alleviate the more fundamental problems we have identified as leading to joint action. Competition for credit would remain. Public demands for both levels to intervene would not abate. Governments would still want to intervene in ways which would spill over to other governments. The preferred programs and priorities of the two levels of government would still differ. Nevertheless, as a first step to rationalization governments should search out and identify these areas of overlap. More fundamentally, it might be possible to think of a wide-ranging redistribution of responsibilities between federal and provincial governments. Rather than joint action through shared cost programs, the responsibility and the funds would be allocated unambiguously to one level of government. This is the implication of the recent transfer of shared-cost programs to the provinces. Other redistributions might involve formal change in the constitution. The logic here is that of watertight compartments. The difficulty is to identify any important policy area in which one level of government would be content to allow the other to operate alone. Many have suggested that overall economic management is one of the primary federal roles; but provinces may also have a role to play in stabilization policy and have strong views about it. Environmental policy, to take another example, similarly has local, provincial and national dimensions, inextricably intertwined. Policy sharing is a permanent feature of Canadian federalism.

Even if the present policy concerns of government could be rationalized in this way, new policy areas would inevitably arise to cut across whatever new policy boundaries had been devised. Hence, while it would be useful to study policy areas in this light, high expectations should not be placed on a general reorientation of overall governmental responsibilities.

There have been many suggestions for improving the machinery of intergovernmental consultation. Some such improvements are probably necessary but it must be remembered that the machinery is less important to success in negotiations than are the attitudes and orientations of the participants and the nature of the problems facing them. Conflict stems not just from administrative weaknesses, but from real differences in goals and priorities.

It is, however, vital to make a sharper distinction between those elements of the machinery which should be open to public view and those which should remain private. The Victoria Charter restricted its proposals about machinery to the requirement of a yearly meeting of First Ministers. This should be retained with the additional stipulation that at least one such meeting be open to the press and provide an opportunity for general public discussion of major issues facing the federation.

Consideration should be given to strengthening the role of the Intergovernmental Secretariat, so that in addition to its housekeeping activities, it would undertake research and other activities at the direction of the eleven governments.

In addition to the regular First Ministers Conferences, it would be useful to have permanent standing committees of ministers, supported by relevant officials' groups, in the most important policy fields. This could permit a more regular exchange of information.

The intergovernmental bargaining process has grown up largely separate from Parliamentary institutions, and without adequate mechanisms for scrutiny and ensuring accountability. Hence, in order to facilitate greater public awareness of the issues and alternatives in intergovernmental relations it is important that the federal Parliament and provincial legislatures have greater opportunity to study and assess them. Specific responsibility for the oversight of intergovernmental activities – municipal-provincial as well as federal-provincial – should be assigned to permanent committees of the legislatures and federal Parliament.

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Federal-Provincial Grants and Equalization

Geoffrey Young

This paper discusses some of the arguments for and against conditional, unconditional and equalization grants from the federal to provincial governments. Some possible amendments to the existing equalization program are suggested. The paper also contains calculations of the effects of some federal grant and expenditure programs in equalizing provincial spending power.

The division of taxing and spending powers between the central and provincial governments is one of the most important determinants of the nature of any federation. In Canada this issue is closely related to that of grant payments from the federal to provincial governments, for such grants have often been seen as substitutes for the surrender of "tax room" (that is, for reductions in federal tax rates designed to allow provinces to increase their tax rates correspondingly). The several types of grants and the surrender of tax room can have important effects on the financial decisions of governments. This paper is intended to provide background information and summarize some of the advantages and disadvantages of various types of federal grants and of other federal programs with similar effects.

Grants by the Canadian federal government can be divided into *conditional* grants, which require some action on the part of the receiving province

Dan Markovich assembled the data and performed the calculations found in the last two sections of the paper. Douglas Hartle and John Buttrick provided valuable comments on earlier drafts.

(usually spending money on a designated program) and *unconditional* grants. The first two sections discuss some of the arguments for and against the two types of grants. *Equalization* grants, the sub-category of unconditional grants that have the purpose of assisting provincial governments of the poorer provinces, are discussed in a separate section. The remainder of the paper estimates the equalizing effect of the grant system and of some major federal programs, and briefly describes the new federal-provincial fiscal arrangements.

Conditional Grants

Many federal grants to provincial governments are given with the condition that the province spend some amount, usually more than the grant itself, on a specified program. Until very recently the largest of these conditional grant programs, for health care, higher education, and welfare, consisted essentially of a federal grant of about half of whatever amount the province chose to spend on the particular program. Such conditional grants from the federal government accounted for a substantial fraction of provincial government revenues. Conditional grants have tended to be unpopular with the provinces, who consider that such grants effectively impose federal priorities on provincial spending; this of course is precisely their purpose.

Beginning in 1977 the cost-sharing programs for health care and higher education will be replaced by the transfer of tax points, further equalization grants, and grants of predetermined amounts to provinces with programs meeting certain standards. The controversy over conditional grants will thus lose much of its heat. Some conditions are still attached to these programs, however, and there remain many small conditional grant programs. It is therefore worth examining the arguments often given for retaining conditional grants.

A COMMON MINIMUM STANDARD OF SERVICES

Conditional grants to provinces have been justified on the ground that the federal government has a duty to ensure that all Canadians enjoy common minimum standards of certain social services, health care and education even if these responsibilities fall within provincial jurisdiction. It is argued that federal conditional grants induce greater provincial expenditures in policy areas that would otherwise be neglected.

The "common minimum services" argument, though its proponents generally do not say so, seems to rest on at least one of several specific assumptions: (i) The decisions of provincial governments do not reflect the wishes of their constituents. (ii) The provincial governments are technically incompetent to take action in some fields constitutionally within their juris-

diction. (iii) Although the decisions of provincial governments may express the wishes of their own constituents, the residents of other parts of Canada, acting through the federal government, should be able to impose expenditure programs the latter feel to be desirable.

When stated in this way, the proposition seems much less acceptable, provided one believes that the provincial governments are as legitimate an expression of the democratic process as the federal government.

SPILLOVERS

Probably the most persuasive economic argument for federal cost-sharing grants to provinces is that provincial programs may have benefits that spill over into other provinces. Because the province paying for the program obtains only a part of the benefits it will tend to spend too little on it. For example, a province spending money on higher education or professional training may reap only part of the return on its expenditure if educated individuals move from the province, carrying their skills with them. The benefits of research may similarly spill over provincial and national boundaries.

It is not clear, however, that federal cost-sharing grants are the best way to handle such spillovers. First of all, in many fields spillovers are surely too small to justify cost-sharing at as high a rate as 50 per cent. Health care in one province can have little effect on the welfare of residents of other provinces, except for a few relatively inexpensive programs such as innoculation of potential migrants and tourists against communicable diseases. When they are given at too high a rate, i.e. do not match spillovers, shared-cost grants may generate excessive expenditure because a province bears only part of the cost of expenditure on the program. For some fields, such as higher education, spillovers are undoubtedly much larger, but probably vary so much between provinces that cost-sharing at the same rate for all provinces does not increase the efficiency of government spending. If higher education does indeed have benefits for society at large, a small province that sees many of its educated people leave and that has only small opportunities to apply pure research would require a far higher rate of cost-sharing to induce sufficient spending (assuming it makes spending decisions for the benefit of taxpayers of the province rather than for the benefit of the educated person) than would a large province with many opportunities for employing the educated and for application of university research.

In spite of these caveats, spillovers remain a legitimate justification for conditional grants. The problem lies in determining the size of spillovers and designing a fair and efficient grant program to offset them.

ELIMINATING BARRIERS TO MOVEMENT

Most Canadians would agree that the unhindered movement of people within Canada is desirable for its own sake. It can also be argued desirable

for economic efficiency that people should be able to move to areas where their opportunities and productivity are highest. Provincial programs can create barriers to this free movement. A province adopting a "no-growth" policy could conceivably make itself a most unattractive destination. It could limit access by recent arrivals to welfare, health care and (as is already being done) higher education (see Trebilcock *et al.*, in this volume). Provinces giving renter assistance credits now typically discriminate against recent arrivals by allowing only rent and property taxes paid in the province to be used as a basis for tax rebates.

Federal standards, enforced by means of conditions on grant programs, could limit many such barriers. It is to be hoped, however, that some other means of persuading provincial governments to accept the principle of non-discrimination, a means without the many disadvantages of conditional grants, will be fóund.

EQUALIZATION

Conditional grants in Canada have typically had the effect of equalizing spending power among rich and poor provinces. For example, while the Atlantic provinces received (1975-76) 10 per cent of payments made under the major cost-sharing programs, taxpayers in the region contributed (at a rough estimate) only about 6 per cent of Federal tax revenue (Courchene, 1976b). Taxpayers in the region were thus net beneficiaries of the programs. Any desired equalization of spending power among provinces can however be achieved by means more suited to the purpose than conditional grants. We return to the subject of equalization in a following section.

Unconditional Grants

Unconditional grants require no specific expenditure by the receiving government and thus meet some of the major objections to conditional grants. They do not impose the priorities of the federal government on the provincial governments and they do not induce excessive expenditure on programs aided by grants.

Unconditional grants, including equalization grants, do however have a less quantifiable but possibly equally serious drawback; they necessarily result in a divorce between the responsibility of taxing and the privilege of spending. The destruction of the link between taxation and expenditures means the political benefits of spending are enjoyed by a government that does not suffer the political costs of imposing taxes. As a result the general level of government spending is determined not by government decision-makers weighing the advantages and disadvantages of taxing and spending,

but rather as the result of a struggle between the leaders of the two levels of government. The outcome of such a struggle is likely to depend on such accidents as the response to growth or inflation of various types of tax revenue.

Equalization

The equalization program is a set of unconditional grants that attempts to reconcile the conflict between the decentralization of decision-making which, it might be argued, is the chief object of having a federal rather than a unitary system of government, and the equitable treatment of Canadians in all parts of Canada.

If decentralization were achieved by simply passing on both taxing and spending power to lower levels of government, then differences in the per capita taxable capacity of different regions would mean individuals in similar economic circumstances, but living in different provinces, would bear very different tax loads or enjoy disparate levels of public services. Many Canadians would find such disparities inconsistent with their concept of nationhood. Only transfers from richer to poorer regions can prevent unequal treatment of similar individuals in different regions.

The amount of inter-regional redistribution that is desirable is, of course, primarily a political and moral question. There are, however, some economic efficiency effects of redistribution. Were the federal government to attempt no equalization and simply withdraw from many tax fields to the greatest possible extent consistent with raising enough revenue to finance its own programs, the enormous differences in provincial tax rates and/or public services that would result would have the effect of encouraging migration to areas of low tax rates. This encouragement to migration could be substantial. Even given the present equalization program, provincial personal income tax rates range from 26 to 42.5 per cent of federal tax, and sales tax rates range from zero to eight per cent. There are also differences in taxes on gasoline, alcohol and tobacco, in direct provincial grants to taxpayers, and in property tax rates (resulting partly from variations in provincial aid to municipalities). These tax rate differentials, (which primarily reflect differences in tax bases, not in public services) may even now be a substantial incentive to move from high to low tax provinces. This incentive, which depends on the natural resources of each province and the income and wealth of its residents, need not correspond with the incentives provided by the free market, which depend on employment and business opportunities, climate and natural amenities (Buchanan and Wagner, 1970). The incentive to move to wealthy areas also increases with the degree of income redistribution taking place

within each province. For example, a general introduction of provincially financed negative income tax schemes would tend to make wealthy provinces yet more attractive, and thus efficiency would require more equalization. On the other hand, it has also been argued (Scott, 1950) that other federal programs discourage needed emigration from the poorer regions and that equalization only adds to this effect.

MECHANICS OF THE EQUALIZATION PROGRAM

The Canadian equalization program is a federal program of direct payments to provincial governments. In its present form the program dates from 1967. The legislation was renewed, with minor amendments, in 1972, and is to be extended in 1977 for a further five years without fundamental changes. The federal government paid out more than $1.9 billion to the seven poorest provinces under the program in 1975-76.

The calculation of equalization payments is complex. Equalization is based on a list of 22 revenue sources, ranging from the personal income tax to water power rentals and race track taxes, and including most of the ways provinces have of raising money. For each tax source a representative tax base is defined. For example, the base for gasoline taxes is simply the number of gallons sold in the province. Then the amount each province would collect if it were to levy a tax at the average Canadian tax rate on its own (uniformly defined) tax base is calculated. Of course, the province may actually use a slightly different base or may even not levy the tax at all. If the yield calculated in this way is less than the average per capita yield of the tax on that base for the nation as a whole, the province is entitled to a payment sufficient to make up the difference. If the province has a larger than average per capita tax base for a given revenue source the surplus is subtracted from its total equalization entitlement.

If most of its important tax bases were larger than average, the province, if the formula were followed, would be faced with a negative equalization "payment". Provincial governments are not required to contribute to the equalization program, however. Provinces with larger than average total tax bases (in recent years Alberta, Ontario and British Columbia) simply receive no payments. The other seven provinces receive equalization. Because its population is large, Quebec receives about half of all equalization payments, although payments to the Atlantic provinces are higher per capita.

EFFECTS OF THE EQUALIZATION FORMULA

The method of calculating equalization payments has a number of consequences that may affect the tax policies of provincial governments.[1] Changes in tax rates, for example, affect equalization payments by changing the total

[1] Much of the following discussion is based on Courchene and Beavis (1973) and on Courchene (1976b).

amount collected from a particular tax. This affects the weight given to that tax in the formula. If a "have-not" (equalization payment-receiving) province increases its tax rate on a tax base in which it is poorer than average it will increase its equalization payment. If, however, it increases its tax rates on a base in which it is richer than average (and every province but Prince Edward Island is richer than average in at least one source of taxation) its equalization payment will be reduced. Thus the receiving provinces have an incentive to tax most heavily those bases in which they are relatively poor. This effect is unimportant for a small province, since its actions will have little effect on national totals, but can be substantial for a large province.[2]

Changes in tax bases also affect equalization. A "have-not" province with a tax base that increases in size will suffer a decrease in equalization payments that may even be greater than the increase in the province's revenue. Therefore if a province has some control over the tax base it may not wish to expand it. An example is a natural resource find by a "have-not" province. If all revenues were equalized, permitting exploitation of the find could produce no net revenue for the province. The entire benefit would be reaped by other equalization-receiving provinces and by federal taxpayers. This anomaly has been corrected by a recent change in the program that limits equalization of revenues from depleting resources.

The government of Ontario has no direct interest in the oddities of the equalization formula because minor changes in its own equalization "entitlement" are not sufficient to bring Ontario into the range where it would receive equalization payments. Ontario taxpayers, on the other hand, as contributors to the federal treasury have a strong interest in the mechanics of the equalization formula. A Quebec government that raises its income tax rates and thereby its own (and other provinces') equalization entitlements, is essentially taxing Ontario taxpayers as well as its own.

EQUALIZATION AND OIL PRICES

The most dramatic instance of the effects of the equalization formula on Ontario taxpayers resulted from the rise in the world price of oil. Combined with changes in tax legislation, this rise greatly increased the Alberta government's potential resource revenues. As oil and gas revenues rose the equalization entitlements of all the provinces with smaller than average bases in those tax fields (that is, all but Alberta and Saskatchewan) rose. The federal government paid out more in equalization payments to "have-not" provincial governments. For Ontario and British Columbia, however, total "entitle-

[2]For example, Courchene and Beavis (1973,495) estimate that in 1968-69 Quebec could have raised $12.5 million by raising its personal income tax rate one point. This would have increased its equalization entitlement by $500,000. Raising the same funds by higher taxes on water power rentals would have decreased its entitlement by $2.5 million.

This aspect of the equalization formula means that the present equalization grants are not entirely unconditional; for a large province they have some of the characteristics of conditional grants.

ments" remained negative so they still received no payments. Taxpayers in Ontario and British Columbia who paid federal taxes to finance the equalization program thus suffered net losses as a result of the rise in oil prices.

If the Canadian price of oil had risen to the world price, and if the equalization program had remained unchanged, the program would have affected the entire structure of government finance in Canada. One writer (Courchene, 1976a) has estimated that equalization payments would have risen more than four billion dollars above their level of 1973-74. Canadian taxpayers might have faced a 25 per cent increase in federal tax rates (offset, of course, by lower provincial tax rates). At these high revenue levels even Ontario would have received equalization payments, so that each $1 of additional revenue for Alberta would have required the federal government to spend about 90 cents on equalization.

The federal government took a number of steps to prevent such an outcome. The domestic price of oil was pegged below the world price by means of an export tax and import subsidies, and oil royalties paid by corporations were declared not deductible for tax purposes. Thus the share of revenue from oil resources accruing to Alberta and Saskatchewan was cut. In addition the equalization formula was changed. It was decided to take account in the equalization formula of only one-third of the additional revenues resulting from the higher international price of oil. The remaining fraction would be ignored. Under the 1977 arrangements the fraction of all depleting resource revenues to be equalized has been changed to one-half.

Partial equalization of revenues from depleting resources has been justified on the grounds that revenues "are of a temporary nature" (Department of Finance, 1976,2) i.e. they represent a sale of a fixed stock of natural capital rather than a perpetual flow of income. If this reasoning is accepted, however, it follows that the return on the capital investments made with resource revenues should be equalized, for this return does represent a flow of income. In other words, oil or ore can only be sold once, but the proceeds of the sale can be used to buy shares or build industrial plants that yield perpetual returns. If the proceeds of the original sale are not counted against the province's equalization entitlement, the return should be, just as the return from ownership of a power dam or a forest is. The difficulty of course is to determine the amount to be equalized when the investment is made in public capital rather than in stocks and bonds. A road or hospital built with depleting resource revenues may well yield a large return, but one that is difficult to calculate.

POSSIBLE MODIFICATIONS OF THE EQUALIZATION SCHEME

The energy price situation highlights one of the fundamental weaknesses of the present equalization scheme. From the point of view of Ontario taxpayers the central issue of the equalization program is simply how much

income redistribution it should bring about. Yet we have seen that the total amount of equalization paid out depends on such factors as the types of tax the "have-not" provinces choose to use to raise revenue, on resource discoveries and on the actions of a foreign oil cartel. If the purpose of equalization is to transfer funds from wealthier to poorer provinces in order to permit all provinces "to provide adequate services (at the average Canadian standard) without excessive taxation (on the average Canadian basis)", as the Rowell-Sirois Commission originally suggested *(Report of the Royal Commission on Dominion-Provincial Relations,* 1940, II, 84),then it is difficult to justify dramatic changes in the size of the equalization program based on the factors mentioned above, which are quite unrelated to any measures of "adequate services".

Alternatively it could be argued that equalization should be not merely a means of allowing the poorer provinces to provide some minimum level of services, but rather a means of allowing all Canadians to enjoy a share of any rich tax base in Canada, no matter how large. If this argument is accepted then total equalization payments should indeed depend on all provincial revenues. In this case, however, it is difficult to justify a system that would throw on all federal taxpayers the responsibility of equalizing revenue accruing to only one or two provinces. In practical terms the present system means that events in Alberta and Saudi Arabia determine the net transfer via the equalization program from Ontario and British Columbia taxpayers to those of the other seven provinces.

One possible alternative is a system where those provinces receiving unusually large tax revenues pay them directly into an equalization fund. One suggested scheme (Courchene 1976b; see also Helliwell 1977) would have a primary level of equalization similar to the present system but based only on the major tax sources used by the federal government (such as income and sales taxes) plus a second level based on those tax sources largely outside federal control (such as resource taxes). This second level of equalization would involve payments directly from "have" to "have-not" provinces, but equalization would tax away only a fraction of these revenues. The benefit of new resource exploitation would then be largely retained by the resource-owning province, whether "have" or "have-not".

Other Sources of Equalization

The equalization program is not the only federal program that has the effect of transferring spending power from richer to poorer regions of Canada. Most conditional and unconditional federal grants also have some equalizing effect, simply because residents of richer regions on average pay

higher federal taxes per capita than do those of poorer regions, while payouts by the federal government do not normally favour richer regions. It is interesting to compare the situation in recent years with that which would have existed if the provinces themselves had financed the major programs that have been aided by grants (health care, post-secondary education, and welfare). The provinces would probably have drawn the required revenue primarily from higher personal and corporate income taxes and sales taxes. The federal government, needing less revenue, would presumably have reduced its taxes in these areas. We assume in the following discussion that tax bases would have been divided between the provinces in the same proportion as at present; in other words that the provinces in strong positions would not have imposed more than their present share of taxes on corporations operating in several provinces or on goods crossing provincial boundaries.

Compared to this hypothetical provincially-financed situation, the federal-provincial shared-cost programs such as Hospital Insurance, Medicare, the Canada Assistance Plan and Post-Secondary Education resulted in substantial redistribution. In 1975/76 alone, these four programs saw Ottawa transferring nearly $3.8 billion to the provinces. If we compare the receipts of each provincial government to the amount of the federal taxes used to finance the transfers that are paid by residents of each province[3], we find that redistribution occurs in the same directions as under the formal equalization program (i.e. the "have-not" provinces experience a net gain, while Ontario, Alberta and British Columbia are financial losers; see the attached table). (Quebec does not participate in Hospital Insurance or Canada Assistance, but instead receives the benefit of additional tax points from Ottawa.)

The equalization program itself is a federal grant program, and its redistributive effect depends on the pattern of taxes as well as that of payments. In other words, not only does the Ontario government receive no equalization while Newfoundland does, but Ontario residents, because of their higher incomes, pay more per capita toward the program than do Newfoundlanders. Thus the program has a greater redistributive effect than the size of the payments alone suggests. Compared to the situation that would exist if the provincial governments had to exploit their tax bases to support their own expenditures, net transfers under the formal equalization program in 1975-76 ranged from a net loss of about $100 per capita in Ontario, Alberta and British Columbia to a gain of over $350 per capita in Prince Edward Island. All the Atlantic provinces gained over $200 per capita, while Quebec, Manitoba and Saskatchewan benefitted less. (See the table.)

[3]The 1975 estimate used in the table comes from Courchene (1976b,23). The calculation allocates personal and corporate income taxes and sales taxes to provinces in the same proportion as the provincial personal income, corporate income and general sales tax bases, as calculated for the purposes of the equalization program. No account is taken of the possibility that taxes are actually borne in a different pattern.

REDISTRIBUTIVE EFFECTS OF SOME FEDERAL PROGRAMS
(In dollars per capita, except where noted)

	Province										All Provinces
	Nfld.	P.E.I.	N.S.	N.B.	Que.	Ont.	Man.	Sask.	Alta.	B.C.	
Approximate % Share of Federal Taxes Raised in the Province[a]	1.41	0.28	2.45	1.99	23.80	41.35	3.83	3.27	8.63	12.88	100
Equalization Payments (1975/76)[b]											
Amount received by provincial government	370	409	296	322	168	0	122	125	0	0	88
Net gain (or loss) to residents*	319	362	237	263	91	(101)	47	55	(98)	(103)	0
Net gain (or loss) as a % of province's gross revenue from own sources[c]	45.3	52.2	38.9	38.4	8.0	(10.6)	5.9	5.5	(5.7)	(8.9)	0
Shared-Cost Programs (1975/76)[b] *(Hospital Insurance, Medicare, Post-Secondary Education, C.A.P.)*											
Amount received by provincial government	193	181	195	194	277**	190	198	194	205	194	167
Net gain (or loss) to residents*	80	73	56	56	64	(51)	26	27	(9)	(60)	0
Transfers to Individuals (1974/75)[e] *(Family Allowance, Old Age Security)*											
Amount received by residents	235	303	264	255	221	227	265	281	220	236	232
Net gain (or loss) to residents*	100	180	107	99	17	(41)	68	94	(40)	(37)	0
Unemployment Insurance (1974)[d]											
Amount transferred (disbursements less premiums)	160	107	53	100	49	(3)	(21)	2	(35)	37	22
Net gain (or loss) to residents*	147	96	38	85	30	(28)	(40)	(16)	(60)	11	0

*Compared to a hypothetical provincial financing of the program(s) at the same level, given present allocation between provinces of income and sales tax bases.
**Includes the value of individual income tax abatement received by Quebec as a result of opting out of Hospital Insurance and Canada Assistance Plan.

SOURCES: a. Courchene (1976b, 24a).
b. Federal-Provincial Reporting Office, *Federal-Provincial Programs and Activities* (Ottawa: Queen's Printer; Annual) Table 1.
c. Statistics Canada, *Provincial Government Finance* (catalogue number 68-205) (Ottawa: Queen's Printer; Annual) Table 1.
d. Unemployment Insurance Commission (unpublished data).
e. Canadian Tax Foundation (1976) *The National Finances, 1975/76* (Toronto) 97.

A similar redistribution results from federal transfers, such as Family Allowance and Old Age Security payments, that go directly to individuals rather than to provincial governments. Again such payments represent a substantial net transfer to residents of many of the poorer provinces (compared to a situation where the provincial governments financed the programs). They range from a third to half the size of net equalization transfers to provincial governments in the Atlantic region, and benefit Manitoba and Saskatchewan taxpayers substantially more than does the equalization program.

Another program that also achieves some equalization is unemployment insurance. The redistributive effects of the federal operation of unemployment insurance result from two factors. First, the program does not attempt to approximate true insurance and premiums do not reflect the risks of unemployment in each region. Thus there is a transfer from (mostly rich) regions of low unemployment to (mostly poor) regions of high unemployment. This transfer of course would not take place if unemployment insurance were provincially financed. In addition, the program has normally had an overall net deficit that must be made up from general federal revenue, to which residents of the wealthier provinces contribute more heavily per capita.

The table contains estimates of the redistributive pattern of the unemployment insurance program. Of the provinces, only Ontario, Manitoba and Alberta had an overall surplus of premiums over total disbursements in 1974. (In 1972 and 1973 even they had deficits.) Saskatchewan had a very small deficit, while the other six provinces had sizeable deficits. Allocating the national deficit approximately among the taxpayers of the ten provinces, we find, unsurprisingly, that the four Atlantic provinces were the chief gainers from the program. Quebec also gained from the program and, surprisingly, so too did British Columbia, which is a "have" province for purposes of the equalization program, but which suffers from high unemployment. At the same time two "have-not" provinces, Saskatchewan and Manitoba, joined Ontario and Alberta as financial losers in the program. The same ranking of gainers and losers held in 1972 and 1973 (except that Ontario and Manitoba exchanged positions) although in 1974 the gainers profited more and the losers paid more. Naturally the size of gains and losses from the program depend on the state of the economy as well as on U.I.C. regulations.

The magnitude of the redistribution resulting from the unemployment insurance program is substantial; the gains from the program range up to half the size of the net gain from the equalization program (in Newfoundland). The net loss for Saskatchewan resulting from participation in the unemployment insurance program amounts to over a quarter of its gain from the equalization program.

Most other federal expenditure programs also have some effect in redis-

tributing income between regions. For example, net expenditures by the Department of Regional Economic Expansion are made in the Atlantic region, and to a lesser extent Quebec, while subsidies for railway shipment of grain confer net benefits on the prairie provinces. Industrial Assistance Grants (in 1971/72) benefitted the manufacturing provinces. While individual programs have different effects, it is safe to conclude that federal activities result in greater expenditure in poorer regions and smaller expenditures in richer regions than would take place under a decentralized federal system with greater provincial responsibilities and with no equalization program.

Of total transfers of spending power, the formal equalization program accounts for only a part. Our rough calculations suggest that the equalizing effect of the shared-cost, individual transfer, and unemployment insurance programs we have discussed is about as important as that of the equalization program in the Atlantic region, Quebec and Manitoba, somewhat more important in Saskatchewan. On the other side of the coin, the net loss resulting from operation of the programs to taxpayers in Ontario and Alberta is rather larger than their net contribution to the equalization program.

Conclusions

The above discussion leads to several conclusions, but it is perhaps advisable first to dismiss one conclusion that cannot be drawn from the figures presented here. We have not attempted a calculation of the benefits of Confederation. No calculation of the distribution of the final burden of taxation was attempted; that is, we have ignored the possibility that taxes imposed on an industry by one province may be passed on to consumers in another province in the form of higher prices, for example. We have made a comparison with provincial taxation of the Canadian tax base as it is now allocated between provinces; this allocation represents a political compromise, not economic research about the ultimate impact of taxation. In addition, we have ignored such vital elements as tariff and transportation policy (on these issues, see Simeon 1976).

The first conclusion to be drawn is that, if it is agreed that the existing level of equalization represents the best attainable compromise, a transfer of any of the programs we have enumerated from federal to provincial control should be accompanied by increases in formal equalization sufficient to offset the resulting declines in the implicit equalizing effects of the program.

A second conclusion can also be drawn from this discussion. Just as the formal equalization program is vulnerable to manipulation, in the sense that provincial governments can influence the size of their entitlement by their choice of taxes and by other decisions, so is the amount of implicit equali-

zation resulting from the other programs. Provinces exercise some control over their unemployment rates, for example, but the unemployment insurance and Canada Assistance programs reduce the penalty for following such popular but possibly unemployment-increasing policies as legislating high minimum wage rates by throwing part of the burden on the taxpayers of Canada at large.

The new federal-provincial fiscal arrangements agreed on for 1977 perhaps illustrate a response to these problems. Large shared-cost grants for health and post-secondary education are to be replaced partly by reductions in federal taxes that will make it easy for the provinces to increase their own taxes correspondingly. These increased provincial taxes will result in an increase in formal equalization payments, making explicit the transfers implicit in the shared-cost programs. Calculations suggest net transfers under the new arrangements will be quite similar to those that would have occurred under the old arrangements, although slightly more favourable to the Atlantic region and the West and less favourable to Ontario (calculations are based on figures in a Department of Finance 1976 press release).

The new fiscal arrangements will also eliminate the incentive for provinces to obtain larger federal subsidies by spending more. The federal grants that form part of the new system will not vary with spending. Provincial programs must still meet certain federal conditions, so that some element of federal influence over provincial spending remains. Most provinces are now committed to the programs being aided, however, and the new grants may therefore have much the same effect as unconditional grants. If so, they are open to the criticisms suggested in an earlier section of this paper. By channelling a large flow of revenues through the federal treasury, they tend to weaken the links between taxation and expenditure. They aid the poorer provinces more than the wealthier ones, but the degree of equalization the new grants bring about is concealed. If the primary purpose of conditional grants, to influence provincial expenditure priorities, has effectively been abandoned, there are good arguments for returning to the formal equalization program to achieve the secondary purpose of equalizing the spending powers of the provinces.

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Tax Base Harmonization

Donald R. Huggett

This paper discusses the problems that may arise when both federal and provincial governments tax personal and corporate income. The author concludes that while it is practical for the federal government and all ten provinces to define different personal income tax bases (as is now the case in Quebec) serious problems might well arise if all ten provinces defined their own bases for the corporate income tax, as Ontario and Quebec do now.

"It is a sound principle of finance, and a still sounder principle of government, that those who have the duty of expending the revenue of a country should also be saddled with the responsibility of levying it and providing it."

Sir Wilfrid Laurier

This statement may be as true today as it ever was. It should perhaps be tempered however to take into account the exigencies of a more modern world which encompasses business and trade which transcends not only municipal and provincial borders, but international boundaries as well. While there can be no question that individual countries must levy and collect their own taxes, they are nevertheless constrained today by the effects of taxation upon business and investment. In the age of multi-national corporations and

trans-border investment flows, any country whose tax system is, by comparison, substantially more onerous than others will ultimately discover that it is a loser in terms of economic activity. This "fact of life" has been recognized and accepted by the European Communities who have now received a directive to harmonize their individual corporate tax systems and to relieve the burden of double taxation (as well as international super-taxation of investment income) by permitting the crediting of taxes paid by corporations against the personal income taxes of shareholders. This "fact of life" is also understood, although sometimes to a lesser extent, in Canada where it is recognized that the tax system of the United States imposes, in effect, peripheral limits upon the Canadian system. Foreign investment is so important to Canada that it must not be choked off or frightened away by a comparatively more onerous (or discriminatory) tax system.

The same principles apply in a federal state as between the states or provinces, except that they apply to a much greater extent. Because there are no trade barriers or customs duties within a federal state, no barriers to the movement of people, and possibly no great differences in political and social systems and economic climate, it is extremely difficult for one province to offset or compensate for significant tax rate differentials. It is much easier to move business across provincial borders than it is to move across international boundaries and it could thus be said that it is virtually mandatory that provincial tax systems – at least insofar as business is concerned – be comparatively equal. This can be achieved by the adoption of similar systems with fairly equal rate structures or by the imposition of a single system by the federal authority. Where comparatively equal systems do not exist or are departed from, time and competition will tend to restore the balance.

In spite of the general conclusion that tax systems ought to coincide, there is nevertheless a great attraction to be "maitres chez nous" and to search for ways to make the tax system both responsive and responsible. This dictates that municipalities levy their own taxes for municipal purposes. It suggests that the provinces should levy their own taxes to finance the perceived needs of their residents and it suggests that the federal government should be restricted to levying taxes only to cover the responsibilities allocated to it.

Under the existing Canadian income tax system the "tax base", that is to say the amount of income subject to tax, is determined by federal rules, but the provinces are free to establish their own rates of tax and may also, within certain limits negotiated with the federal authorities, provide tax credits or similar abatements. The taxes, both federal and provincial, are collected by one agency – the federal government. The only exceptions are Quebec, which collects its own income tax, both corporate and personal, and Ontario, which collects its own corporate tax. However, both the Quebec

and Ontario tax acts are almost invariably altered each year to conform with changes made to the federal statute. This practice, or experience, may be sufficient in itself to point out that separate taxation by each province would be a costly endeavour with virtually no benefit.

The Rowell-Sirois Commission in 1940 stated that "duplication of services for the collection of taxes obviously increases costs both of government and of tax compliance" (*Royal Commission on Dominion-Provincial Relations*, 1940, Book II, p. 177) and went on to recommend that personal income taxes, corporation taxes and succession duties should be levied solely by the "Dominion Government".

The Smith Committee in Ontario in evaluating that Province's fiscal arrangements in 1967 noted that tax-sharing arrangements were not particularly favourable because the taxpayer is not sufficiently aware of the ultimate destination of his tax dollar and the provinces do not have the responsibility of legislating their own taxes. On the other hand, some details of the cost of collecting personal tax revenues were provided and it was concluded that the costs and the burden on taxpayers did not justify the separate collection of personal income taxes.

The Belanger Commission in Quebec noted in 1965 that where tax fields are shared, the scope for action by any one of the governments is severely restricted and that, in fact, they cannot be used as social or economic policy instruments without both governments agreeing to the objectives.

The Carter Commission recommended quite strongly in 1966 that the federal government should ensure that the tax system does not become either a weapon with which the strong provinces tyrannize the weak provinces or a means of erecting barriers between provinces. The Commission was quite emphatic that the "tax base" should be the same in order to avoid an administrative mess and the disastrous degeneration of the tax system into eleven uncoordinated and competitive tax systems. In its view, "it would be a tremendous loss to all Canadians if this common income tax base was not maintained" *(Royal Commission on Taxation*, 1966, 187). The Commission went on to suggest that Ottawa should have the dominant role with respect to personal and corporation income taxes and that it should continue to assume the major responsibility for redistribution of personal income.

The pressures against conformity were nevertheless recognized by the Commission which stated "We are under no illusions that it would be an easy matter to achieve common tax bases, harmonized tax rates and joint tax collection arrangements. The drive for greater provincial autonomy is extraordinarily strong. The desire to have complete fiscal independence for each province as a matter of right, and as a tool for achieving provincial objectives, would make it difficult to persuade some of the provinces to work more closely with the federal government and other provincial governments in the tax field. The potential gains from success are so great, and the

potential losses from failure so heavy, that we have no hesitation in urging the federal government to strive to attain these goals despite the serious obstacles that may be encountered" *(Royal Commission on Taxation,* 1966, Vol. 6, p. 188).

In spite of the almost overwhelming conclusions of the various Royal Commissions and special committees that there should be uniformity with respect to income taxes in Canada, pressures still exist for separate provincial income tax systems. These pressures are generally the result of different political ideologies or the perceived advantages in pursuing different economic objectives.

While there is no doubt that different provincial rules and policies increase the costs of compliance and collection, there is nevertheless something to be said for competition between the provinces for tax resources which, by and large, may be used to attract industry or to develop a more equitable tax system. If the burden of taxation is constant throughout the country, those provinces with natural economic disadvantages will continue to be economically depressed. If, on the other hand, the provinces could offer particular advantages or incentives to industry or special segments of it, a more even distribution of industry and wealth might be achieved.

Advantages of Separate Systems

There is general agreement with Sir Wilfrid's statement that those responsible for spending money ought to be saddled with the unpleasant chore of raising it. This suggests that all levels of government must have access to revenue sources whose yield can match their expenditure responsibilities. Since income taxes are the most elastic and the most responsive to the economic situation, governments with varying expenditure responsibilities should have full access, so it is argued, to the income tax field. As well, since the most regressive taxes – those imposed upon property and sales – are levied by the provinces and municipalities, access to the income tax field by the provinces may be necessary if it is desired to redress the balance and integrate the regressive taxes with the progressive income tax system. It is also argued that tax policy must become a tool for taking advantage of strengths and opportunities; to support economic strategy and be an instrument to achieve goals. This is certainly true at the federal level and must therefore be as relevant at the provincial level.

Separate income tax systems provide freedom to each level of government to determine its own economic and fiscal policy, to redefine the tax base, to provide incentives, or to levy differential rates. Separate provincial tax systems would also provide more freedom to the federal government,

which could then make changes without concern as to their impact on provincial revenues; that is, the tax revenues of the provinces could not be eroded by unilateral federal action. By the same token, perceived inequities or incorrect decisions of the federal government (it cannot always be right) can be partially offset or blunted if separate provincial systems exist.

Another advantage of separate provincial systems is that they could be used as a collection and enforcement mechanism, or a distributive vehicle, for other provincial programs. Thus, health and hospital premiums or other contributions to provincial welfare plans could be collected through the tax system, and transfer payments or tax credits handled by means of the income tax returns.

Each government would maintain its audit rights with separate systems. While this is not always a significant advantage (it can be costly or may result in revenue losses), it may be important insofar as the allocation of business income amongst the provinces is concerned. With a single system enforced by the federal government, the allocation of income between provinces is quite unimportant to the federal authority and some provinces may feel that they are suffering an inequity.

Finally, with separate provincial systems the taxpayers would become aware of the destination of their tax dollars and could exert pressure or criticism at the proper level in the hierarchy. A single system reduces taxpayer awareness and may tend to increase complaint or intolerance.

Disadvantages of Separate Systems

By far the greatest disadvantage of separate income tax systems is their cost from both public and private points of view. Apart from the administrative cost, one must also consider the loss of revenue through evasion which could be substantial with separate systems.

Public sector costs of collecting income taxes might more than double if separate provincial systems were introduced. Apart from the duplication of collection offices, assessors and other administrative costs, the efficiencies of size or scale and the advantages of sophisticated computers and programs would be reduced. As well, the human expertise and resources so patiently built up by Ottawa over the years might become diffused or scattered, if not lost entirely. While these costs or losses cannot be measured, they should not be discounted.

It is more difficult to assess the likely increase in private sector costs. The cost for individual taxpayers who prepare their own income tax returns is only a function of time and annoyance. However, more taxpayers would seek professional help if multiple tax systems were to proliferate. At the

other end of the spectrum, the compliance and administrative costs to large national businesses could increase almost ten-fold. Of particular importance is the fact that most accounting systems are designed to produce the requisite information for one tax system. The cost of redesigning systems for multiple tax jurisdictions is inestimable. It is perhaps worth noting here that the Province of Quebec was virtually forced to adopt the federal capital cost allowance system by pressure from business which found it so expensive to maintain two separate depreciation schedules or records. While it can be said that separate tax systems do not necessarily mean non-uniformity in all areas, it is presumed for the purpose of these comments that separate tax systems do imply a degree of differentiation – because if not, there would be no point.

The advantages of uniformity and simplicity cannot be measured, but should nevertheless not be discounted. It is not possible to develop concrete figures, but the cost of tax reform at the federal level must have been stupendous. To "go round" again with separate provincial systems could be as costly. Business regards duplication as inefficient, and may well turn against the provinces that impose separate tax systems unless there are significant tax savings.

Apart from the actual costs of administration and collection, separate tax systems may result in double taxation if there is no common formula for the allocation of income earned by business and individuals in different provinces, or for establishing taxation rights where individuals move from one province to another. At the moment, a common allocation formula is applied throughout Canada with the supposed result that double taxation cannot occur. However, problems are still encountered by individuals who move into, or out of, Quebec, where income tax has been deducted at source for the province of initial residence. In many cases, the individual is required to pay the full amount of tax due to the province of ultimate residence and to wait for a refund from the province of initial residence. Eleven separate systems would compound problems of this nature.

Without a common allocation formula, double taxation of business profits is bound to arise. While a common allocation formula might be agreed upon initially by all provinces, it seems unlikely to be retained in the long run as the different economic situations of the provinces are analyzed. The formula now in use throughout Canada gives equal weight to the value of sales made and wages paid in each province, but ignores capital investment completely. Many arguments can be advanced to the effect that this formula is quite incorrect from an economic point of view, and it seems likely that different formulae would be developed to meet regional needs. Experience with the allocation formula in Ontario and Quebec where separate corporation taxes have been levied has been favourable in that both provinces seem anxious to avoid double taxation and will usually confer between themselves

to ensure that a common interpretation is followed. Nevertheless, any change in the taxpayer's initial allocation results in the requirement to pay tax to one province and then hope for a refund from the other. The cost of this time lag is not inconsequential. The problems would be enormous if all provinces adopted separate tax systems, even if they agreed upon a standard allocation formula. It is unlikely that all provinces would be so anxious to avoid double taxation and they could become quite militant in enforcing the formula for their benefit. The cost to national businesses and the annoyance consequent upon changes would be significant. Some corporations might attempt to circumvent the allocation problem by incorporating separate companies in each jurisdiction. This might merely compound the problem, however, as losses could not then be offset within a group and inter-company sales or transfers would be subject to tough scrutiny by the various provinces.

It is difficult to evaluate the significance of other disadvantages arising from separate tax systems. One that cannot be ignored, however, is the question of taxpayer integrity. When the same taxpayer has to pay income taxes to two or more authorities which have different definitions of taxable income, or which allow different exemptions, or which adopt different systems of progression, or between which there is a dispute as to primacy, that person is likely to be a more than usually unwilling taxpayer. Furthermore, he will make value judgements as to the fairness of each system and will undoubtedly place one ahead of the other, with the possible result that he may well be encouraged to attempt to avoid – and even evade – the taxes imposed by that system judged to be less fair.

In the international area the advantages of tax treaties with other countries would be lessened because the provinces cannot conclude treaties with other nations. Since the federal government cannot bind the provinces, other countries would be less likely to conclude favourable treaties with Canada.

Separate tax systems introduce significant difficulties where appeals are involved. Apart from the fact that appeals may have to be instituted in several provinces to sustain a particular point of view, there is the likelihood that different decisions may be reached in different provinces. Another disadvantage of separate tax systems is that they are an obstacle to freedom of movement within the country.

Conclusion

While one could easily conclude that the disadvantages of separate tax systems outweigh by far the advantages, economic realities must often give way to political or emotional objectives. To the extent that the latter out-

weigh the former, one can only suggest that a compromise – in true Canadian fashion – ought to be sought. One that appeals – if compromise is required – is that the provinces enact their own individual taxation statutes, but agree to a common base or system for the taxation of corporate income. Such a compromise would allow each province to deal with its residents on an individual basis according to perceived needs or policies, but would not create a "tax jungle" which could be detrimental to the whole of Canada. Individuals, with a few exceptions, would only be subject to tax by the province in which they reside and by the federal government. Many corporations, on the other hand, carry on business in many provinces and there is therefore a more pressing case for them to be subject to a common regime.

While the taxation of business can have economic consequences, it is submitted that differentials in this area will do more harm than good and that the provinces can achieve their own particular objectives more usefully through the individual tax system than they could hope to achieve through the differential taxation of corporate profits. Generally speaking, provinces do not provide benefits or services to corporations in the traditional sense and thus differential tax burdens can only be interpreted in that light – as differences in burdens. While this may also be true in the personal area, individuals can relate any additional burdens to services provided and to the quality of life. Governments are elected by people, for the people, and they will want to please the electorate within the bounds of economic reality. If so, their attentions ought to be directed towards the individual tax system rather than the corporate.

A common or standard tax system would probably serve Canada best, but if second best were considered for provincial autonomy or economic objectives – which seem to be important – the provinces should seriously consider the proposition that individual income tax systems can vary, but those applying to corporations cannot.

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Jurisdiction Over Natural Resource Development and Revenues

Anthony Scott

This paper first looks briefly at the constitutional and historical background to the debate over the distribution of natural resource revenues. The remainder of the paper is devoted to unfamiliar economic, rather than distributional, aspects of the question of which level of government can manage natural resources best. The author concludes that there is no reason to believe federal management of resources would be more efficient than provincial management. Nevertheless the desirability of some interprovincial redistribution may necessitate national collection of some share of these revenues, and the acceptance of some national management of resources.

1. Introduction

This paper presents a brief outline and analysis of issues falling under the heading of Natural Resources, that beset the peace of intergovernmental relations. These are of three general types:

(a) The constitutional validity of provincial or national natural resource policies;

(b) The right to collect natural resource revenues; and

(c) The right to manage or regulate natural resources.

In the early part of the century, there were a number of important suits concerning the validity of provincial claims to regulate or tax mining, oil, fisheries and forestry. The recent referrals to the Supreme Court of Canada

of questions about rights to oil deposits off the Atlantic and Pacific shores are attempts to avoid future litigation on similar subjects. Such strictly constitutional questions are not the subject of this paper.

In the 1970s the public has seen chiefly the second and third type of issue. No new federal-provincial issue had arisen in the 1940s, 50s, or 60s, until the Carter Commission (the Royal Commission on Taxation) reviewed, among other matters, Ottawa's tax provisions for capital gains and depletion allowances. Because nearly all the provinces had been reshaping their management of their public domains (under the guidance of omnibus Royal Commission reports), the proposed new policies incurred the opposition of industries who had counted on the continuation of pre-war give-away, subsidy, and tax-incentive policies. The first of the Carter reforms, the withdrawal of the three-year tax holiday period for new mines, was introduced in 1972. But the rest were postponed until 1976.

The public and the industry were perhaps slow to see that these more stringent federal tax policies also imposed a threat to the strengthened provincial resolve to abandon their previous promotional and developmental tax and management approach. Natural resource revenues, as we will see below, were becoming of negligible revenue significance. New types of royalty, mining and logging tax were being discussed and introduced. Local school taxes were becoming more of a burden to loggers and miners. In other words, provincial governments were abandoning incentive policies and were introducing new natural resource revenues in forms that could be allowed as expenses under federal income and profits tax. The Carter logic, that federal taxation policies should treat mines and forests as much as possible like other industries, was bad news to provinces as well as taxpayers.

The third type of dispute concerned the management of resources. This subject had been the subject of various compromises: hydro power and water resources in the 1950s, energy export, uranium production and pipeline regulation in the 1960s, environmental and ecological jurisdiction in the 1960s and 1970s, not to mention minor understandings concerning Indian affairs, fisheries and national parks. But most observers would have conjectured that these disputes were marginal, the main questions having been settled. In the early 1960s in a symposium at the national "Resources for Tomorrow" conference, an all-star team of constitutional experts (including Bora Laskin, Pierre-Elliott Trudeau, F. R. Scott and L.-P. Pigeon) agreed among themselves that there were no gaps in the constitution so far as resources were concerned: every possible topic was covered at least once, and very few more than once.

Since then, some important new gaps have emerged, chiefly related to energy policies. So far as natural resource revenues are concerned, public domain rents have skyrocketed and there has been much more at stake than in the previous polite murmurings over the allowances of provincial royalties

and taxes based on these rents. But natural resource revenues were only part of the matter. Equally important has been the value of exploited raw materials at the wellhead or on the stump. In the energy crisis, for instance, federal price control, pipeline and export tax powers have been used to keep down wellhead prices and so not only private profits, but also potential provincial royalties. In less dramatic ways federal policies have threatened the shared-profit of other provincial government-business arrangements. These policies have all tended to reduce the provincial incentive to permit sales to consumers in Canada, and have increased a provincial desire either to encourage exports to the U.S. (if prices there were higher than in Canada) or to leave resources unexploited (if future markets promised more than present federal controls).

In the following notes are presented some economic analysis of the institutional, constitutional and federal issues lying behind the conflicts. Instead of the "rights" mentioned in the second and third type of issue, we focus on the advantages and drawbacks of proposed answers to two similar questions: who should get all the natural resource revenues, and who should be entrusted with managing natural resources?

2. The Debate Over Revenues and Management Powers – Background

This title is perhaps misleading. In general, it has been conceded for many years that the provinces are superior to the central government in respect of natural resource revenue, and in respect of regulation or management powers.

Let us look first at the BNA Act. It is as well to note that the constitution does not set about assigning authority over particular kinds of natural resources: soil, water, fish, minerals, etc. Instead it assigns powers over different categories of legal ownership of land and water; over different types of taxation; and makes very general provision for property and civil rights on the one hand and trade and commerce on the other. Only under these classifications can private actors in natural resource activities determine the level of government to whom they are responsible for their rights and obligations. The general idea is that ownership of public lands, where public lands still exist, is vested in the provinces (Sections 92[5], 109 and 117). Thus, whether to use, or not to use, these lands is a provincial question. Furthermore, the revenue that might be thought of as the equivalent of a landlord's return is owed to the provincial treasury.

This ownership power is reinforced by both the property and civil rights power and the power to levy direct taxes (Sections 92[2] and 92[13]). (A

direct tax is a tax that cannot be "passed on" by the person from whom it is collected). These powers together have been deemed to confer on the provinces far-reaching authority over the management of all lands in the provinces, even those that are not public lands. Thus many writers and speakers, often rightly, do not even distinguish between public and private lands in public disputes about resource jurisdiction.

The constitution does however constrain these provincial powers. Perhaps most important of the qualifications is the assignment to Ottawa of rights to regulate trade and commerce (Section 91[2]). Almost as important, and more often in the news, is the complete freedom of Ottawa to employ any mode of taxation (Section 91[3]); this may conflict directly not only with provincial power to employ modes of direct taxation, but also with provincial ownership rights to collect rents and royalties. Finally, the generality of the provincial property and civil rights power is offset to a certain extent by general federal powers over transportation, agriculture, fisheries and activities or works that may be declared to be essential to peace, order and good government for the general advantage of Canada (Sections 91, 91[12], 92[10a], 92[10c] and 95).

Here are four important headings under which, since 1920, may be listed the various issues wherein the two levels have been in conflict over natural resources:

(a) Direct taxation. In 1974 and 1975, following up one theme of Carter tax reform, Ottawa acted to prevent rapidly-increasing provincial royalty rates from siphoning off corporation profits tax revenue. Royalties and mining taxes were no longer deductible from the tax base. At the same time automatic depletion and instant investment write-off were replaced by depletion earned by actual outlays, while the expensing of exploration and development were modified so that only exploration outlays were fully deductible with development henceforward to be written off like depreciation at 30 per cent per year. To modify the burden of all this, federal corporation tax liabilities were reduced by a resource allowance of 25 per cent of "production income". This did abate somewhat the non-deductibility of higher provincial royalties and rentals.

(b) Indirect taxation. Alberta and other provinces have at various times (e.g. 1928) wished to levy a severance or sales tax on private resource properties. This has been found unconstitutional in decisions paralleling roughly the contemporaneous findings that certain farm-marketing levies were invalid because indirect.

(c) Energy policy. Since the 1971 OPEC-initiated energy crisis, Ottawa has by price control, export taxation and other means limited the provinces' authority over and revenue from their own energy lands, and has enlarged the administrative sphere earliest asserted in the energy export act of 1907 and the national energy act of 1963.

(d) Environmental policy. Although it is to be presumed that most environmental questions are (perhaps as matters of property and civil rights) under provincial jurisdiction, Ottawa has had a surprisingly large role, sometimes in conflict with both the federal Department of Regional Economic Expansion and provincial developmental policy, sometimes reinforcing them. Transfrontier pollution, spills and dumping, fisheries-related pollution and Indian affairs have been most often involved.

Two final comments on this background are in order. First, the provincial power over resources stems largely from some provinces' ownership of a large public domain. The federal government cannot act in a uniform way when in some provinces most citizens or taxpayers are Crown tenants or contractors, while in other provinces they are private owners or tenants. Furthermore, as will be shown below, some provinces' budgets depend heavily on natural resource revenues from both public domain and private sector.

Second, it should be pointed out that Canada is probably unique in that its two levels of government epitomise, within one nation's borders, the interests that elsewhere divide "producer" from "consumer" nations. While it is true that in the United States the natural-resource states, notably Alaska, do have a certain amount of revenue and management power, in general the Congress and the executive branches of the federal government in Washington, D.C. make it possible both to internalise many, if not most, mineral, forestry, energy, fishery and environmental issues, and to reconcile these policies with consumer and manufacturing interests. On the other hand, most OECD members typically regard themselves on raw-material and energy matters either as producers or as consumers – not both. Apart from the separatism of Scotland, they rarely have within their boundaries another level or sphere of government that represents an interest different from that most often heard in the central parliament. Thus, when we think of western Europe or the United States facing OPEC or governments of less-developed countries over primary-product and energy questions, we must recognize that we have the same confrontations within Canada, among regions and their sovereign governments. While the resulting conflict may be deplored by tidy-minded constitutionalists, it might be reflected that this obligation to allocate energy and raw-material resources by inter-provincial diplomacy produces a more peaceful and more just share-out than can be achieved respectively by international or by wholely internal (political) mechanisms.

3. Resource Revenues as Rent

There are two reasons for policy questions being focussed on the rights to capture natural resource revenues. One stems from economic analysis, and one from ethics.

The former comes from the science of public finance. The analytical economist, from the nature of his theory, becomes very keen to capture "rent" for the government. This attitude prevails regardless of the resource on which the rent appears. In economics, an income stream is said to contain a rent whenever it exceeds the amounts strictly necessary to assure the existence and continuance of the services for which it is a payment. Thus the familiar rent of farm land is the amount paid for its use by a buyer or tenant in excess of the payments strictly necessary to make the land available, and to maintain it in reasonable accessibility and condition. The rent (or "royalty value") of mineral or forest land is a similar concept: it is the amount that is or would be willingly paid by a miner or logger for the right to exploit land, above all strictly necessary costs making the land available and accessible. Such rents could be collected by the landlord, but are often left in whole or in part with the tenant or user. The economist's enthusiasm for capturing for government this part of private income is an extension of several related ideas. First, his analysis of the competitive economy tells him that rent is an unnecessary return. It can be entirely removed without reducing incentives or endangering output or quality. Thus if all rent were captured by royalties or taxation, there need be no social cost, no distortion of the allocation of resources. Furthermore, rather less certainly, even if only a varying proportion of all flows of rent were captured in tax revenue, this neutrality of taxation would be maintained.

The ethical idea is just as simple. For the same reason that taxation of rent is neutral and undistorting, the payment of rent is unnecessary and indeed undeserved – "unearned" was the original phrase. The existence of rent is not due to any act by its recipient, but may be attributed to Divine or natural causes. Thus, to paraphrase John Stuart Mill, rent is not a matter of production, its payment is not necessarily a market phenomenon, and its distribution is essentially a social, not an economic subject. The American economist and politician Henry George is today most often recognized for his variations on this central theme, in his 1880s best seller, *Progress and Poverty*. But he was not alone. Dr. Turgot, the philosopher-economist of the pre-revolutionary French enlightenment, Adam Smith a few years later, the Victorian classical economists David Ricardo and John Stuart Mill, the great turn-of-the-century theorists Leon Walras, Vilfredo Pareto and Knut Wicksell, and even such literary writers and popularisers as George Bernard Shaw and H. G. Wells, had similar views. Like George's, their writing proceeded inexorably to urge a particular social decision on distribution: ". . .the rent of the land belongs to the people". The landlord had done nothing, but the community, perhaps inadvertently, had created the particular scarcities on which rent depended.

Canadians have shared these ideas, but in a selective fashion. French-Canadian attitudes to seigneurial tenure, fur-company land claims, and clay-

belt colonisation schemes suggest an impatience with absentee owners, but not with the institution of private property in land. Upper-Canadian attitudes to homesteading, squatting, mineral claims and forest cutting rights, reveal a similar pragmatic attitude to ownership and rent. It might be thought that the widespread acceptance of the notion of the "single-tax" (on land alone) in Western Canada indicates a more principled adherence to Mill's advocacy of a social redistribution of rent. But this would be going too far. In the western provinces, the target was not the landlord, even the absentee landlord, but the speculator who hindered early development and investment by holding land off the market and out of use. The aspect of the single tax that pleased westerners was not the taxation of land and its rent, but the incentives created by the implied exemption of improvements and structures. If proof of this is needed, consider the refusal of socialist farmers to accept the nationalisation of land – the redistribution of rent – as an element of the CCF's Regina Manifesto.

The median Canadian attitude lies somewhere between the extremes. On the one hand, the Canadian involved in resource exploitation rejects most suggestions that "his" resources should have their cream skimmed off by the tax collector, and reinforces his objections by claiming the necessity of his own efforts, skills, and risk-taking for the value produced. But he is not blind to the idea that society has some claim. The rights of provincial governments to a share of property taxes, and to "school taxes" are widely accepted. And, in their turn, Western premiers, even in their most rhetorical vehemence, have never aspired to the mantle of the oil sheiks. A scrutiny of their speeches, even those to their own local taxpayers, reveals an ungrudging acceptance of the idea that "all society" or "Canadians everywhere" have *some* title to western resources. In this they differ from, say, northern, western, and Alaskan Indians whose land claims are, in principle, absolute, or from the nationalists of Arabia, Norway or Scotland who deny that consumers elsewhere have any vestige of a moral claim to "their" oil resources, or the rents therefrom.

4. Resource Revenues as Revenue

The foregoing analysis is important only if natural resource revenues, actually or potentially, are a significant source of gross provincial revenues. In this section we will learn something of their significance. In recent years, Statistics Canada has published a provincial natural resource revenue total that comes close to the concept that economists would desire. It includes revenues from both Crown and private property (exclusive of farm production), from fisheries, forest operations, mines, oil and gas, water power and

miscellaneous other sources. Most of it is so-called public-domain revenue, but an increasing fraction has arisen from taxation of private natural-resource enterprise.

CANADA: PROVINCIAL NATURAL RESOURCE REVENUES
AS A PERCENTAGE OF GROSS PROVINCIAL REVENUES

	Fiscal Year						
	1913	1926	1939	1949	1971	1974	1976
Alberta	–	–	–	–	22	31	48
British Columbia	50	–	–	–	9	15	13
Ontario	–	–	–	–	1	1	2
All Provinces	20	15	9	11	4	6	9

SOURCES: Statistics Canada (various years) *Provincial Government Finance, Revenue and Expenditure* (catalogue no. 68-207) (Ottawa: Queen's Printer); and Scott (1977, 19 and Appendix).

The table shows that, before World War I, Canadian provinces obtained about one-fifth of their provincial revenues from these resource sources. Much of this, we think, must have been proceeds from the outright sale – Crown grant – of the public domain. But already it was not unusual either to retain Crown ownership, or to provide for a contractual or statutory royalty payable even after the resource had been alienated from the public domain.

Except for the depression of the 1930s, the years between 1913 and 1975 were characterised by rising provincial resource revenues. But this base was lost sight of until the 1970s. Instead, taxes on new tax bases, and federal grants, sustained a rising fraction of provincial expenditure. By 1971 less than 5 per cent of all provincial revenues derived from natural resources (an average figure poised between Alberta's buoyant 22 per cent, mostly from oil and gas bonuses and royalties, and Ontario's 1 per cent). Evidently the goal of the provinces was promoting development, not raising revenues. Some statutory royalties and other revenues were never put into effect; others were eroded by inflation, exemption and allowances.

All this was changed during the 1970s. Alberta's resource revenues rose five times in four years, and almost half of her most recent (1975-6) budget came directly from resource revenues. No other province did this well. For one thing, their mineral and wood-product prices did not keep pace with oil and gas values. Nevertheless, B.C.'s natural resource revenue/gross provincial revenue ratio rose from 9 to 13 per cent, Ontario's from 1 to 2 per cent, and that for all ten provinces from 4 to 9 per cent. Truly a remarkable "back to the land" movement.

These revenues are by no means evenly distributed among the provinces. In the 1950s the per-capita natural resource revenues were relatively closely grouped between B.C.'s and Alberta's $10.00 and Nova Scotia's $1.50. But this clustering fell apart in the 1960s and 1970s. By 1971 Alberta's per capita natural resource revenue had mounted to $200, while Nova Scotia's was still less than $2.00.

We must be careful not to interpret all of such natural resource revenue differences as measuring differences in per capita rents. No doubt rents do vary widely. But the revenues received are obviously influenced by differing rates as much as by differing bases. Furthermore, some provinces almost completely alienated their natural resources to private owners many decades ago. Consequently, although the rents may still be there (in private hands), and although the provincial revenues may still benefit indirectly from these early transactions, the consideration no longer shows up as natural resource revenue. The comparative smallness of Ontario resource revenues for example may result from the province having sold many of her resources outright in early years. If the proceeds of these sales were wisely invested, however, they could still be yielding a return. This return would not show up as a resource revenue. In addition, private investment may have been encouraged by low prices charged for the resources; this early stimulus to the provincial economy might still be yielding tax revenue. This tax revenue is not counted as a resource revenue in our table either.

5. The Role of Government in Resource Management

Governments play a number of roles in natural resource management. The most obvious of these is in providing the framework and infrastructure for private managment. Much of this is in the provision of public services exclusively for particular individuals and firms, or, in many cases, for anyone who cares to make use of them, without exclusion. Traditional geological surveys, the publication of geophysical findings, timber protection against fire and disease, basic research concerning technology, transportation and markets – all these are provided. Again, a service for private markets and private property holders is provided in the qualifying and monitoring of professional timber cruisers and scalers, geologists, and stockbrokers, and the licensing of prospectors, fishermen, and others who range over the public domain. Furthermore, the government provides, at considerable costs, infrastructures in the form of subsidised roads, railways, pipelines, water systems, municipal or townsite amenities such as schools and hospitals. Resource developers may use public air and water for the disposal of wastes, without charge. Finally, the government may provide actual management services, connected with permitted or required grade, life, or recovery in petroleum

and mining operations, and with tree cutting and regeneration practices in the woods. Indeed, the government may itself act as explorer, developer or producer.

To this list of regulations and activities must be added the economic incentives of the collection of natural resource revenues. The new mosaic of federal and provincial bases, rates, allowances and exemptions now affects private decisions at every stage. Exploration, scale of development, timing, grade, and processing are now surrounded by an extraordinary network of tax-related influences and constraints. Not all of these were intended to influence resource management. But as one observant writer put it in 1974, it is now impossible even to speak of an average effective rate of mineral taxation; the rates differ so tremendously between provinces with respect to investment in processing equipment, degree of processing carried out, expenditures on exploration and development, intensity of labour use, and so on (Brown, 1974, 335). These variations in rate and treatment, the despair of the tax expert, suggest that, whatever their genesis, the power to collect natural resource revenues also confers powers to use many incentives and deterrents which are in fact instruments of resource management.

The complete list suggests that to ask which level of government should manage natural resources is to miss the point that "management" does not represent the all-over planning of some single Cabinet, Legislature, or identifiable bureaucratic elect. In the first place, "management" powers are largely familiar instruments of regulation, not powers to actively intervene in all matters of land or resource use. In the second place, the management tools and instruments are very numerous, are necessarily spread both among the three levels of government, and also among numerous departments, Crown corporations and regulatory agencies, and are frequently administered with little thought to resource use. Few responsible agencies have responsibilities confined to resource industries. In the third place, direct liaison or contact with the resource industries is often highly decentralised: to an echelon of inspectors, foresters, geologists, district engineers, commissioners, and other functionaries is delegated a surprisingly high-level and final discretion on both regulation and matters affecting the amount of natural resource revenue payable. Finally it is disconcertingly difficult to guess which of the three layers of government has final responsibility for a particular local resource function. Within the patchwork quilt of local officers are representatives of the federal government for fisheries, inland waters and boundary matters; the provincial government on a multitude of public domain matters; and municipalities on local tax, land-use and transport problems. Recognition of this complex pattern, and of the many variants which operate more or less successfully in other federations, leads us away from a search for who holds natural resource powers, to a search instead for criteria or canon for identifying "the best" level to manage resources.

6. Which Level of Government Should Manage Resources?

In this section it is assumed that the question of whether Ottawa or the provinces should have final control in natural resource issues now in conflict is equivalent to asking whether a large jurisdiction (Ottawa) or a smaller one (any province) can do the job better. What are our criteria? If Ottawa is chosen to manage and tax resources, instead of the provinces, there will be implications for (a) the costs of government itself, (b) the effectiveness with which private industry is handled, and (c) the breadth of redistribution of the natural resource revenue. It is not obvious that either level of government has an advantage under all these three headings.

A. COSTS OF GOVERNMENT

The total social cost of government differs according to whether such functions as regulating natural resource exploitation and collecting natural resource revenues are assigned to a higher or to a lower level of government. (Often, this question is analysed according to whether the government serves a large proportion of the economy, or a more localised portion of it). In the final analysis it will be seen that what matters is the cost of "internalisation" of regulation and taxation within the jurisdiction of one high-level government compared to the loss of "external" relations between smaller lower-level governments with respect to the same decisions and administrative actions.

Economics might be assumed to have some ready-made canons on these questions. Unfortunately, because little progress has been made in the world of economics in devising a general theory of the structure of government, applications to new questions become requests to devise a general theory. In that world, even in its public finance underworld, there is scarcely any analytical place in the scheme of things for a government of a variable size and scope, let alone several levels of government. Instead, government is regarded as a given entity imposed from without. The most the economist can do is study the adjustment of "the economy" to the actions and expenditures of government. These latter remain unexplained, as are the institutions of government itself.

We must therefore proceed by referring to two fragments of economic concepts that are often invoked in discussions of such questions.

First, in Canada at least, it is usually assumed that each jurisdiction has some sort of regional justification. The "staple" theorists, who emphasized private transportation costs and the importance of mountains, lakes, and rivers in explaining economic development, encouraged this approach. It carried over into the explanations offered by the Rowell-Sirois Commission of 1940, the Maritime Union Study of the early 1970s, and the background

papers on transportation and on the environment offered to the last (Victoria, 1971) constitutional conference. Indeed, some economic historians taught that Canadian governments are set up for the same reasons as feudal earldoms were created: to foster and protect land-oriented communities.

Second, we may pick up the public finance theorists' preoccupation with the spillovers of taxes, services, pollution, price-levels, multipliers and economies of scale in production and consumption between adjoining economies or jurisdictions. Some writers urge that general political boundaries should be drawn to minimize those spillovers. Others use similar criteria for drawing boundaries around the best set of smaller regions to make up proposed free-trade areas, tax-harmonisation areas, currency areas, fiscal policy areas, anti-cartel areas, uniform pollution law areas, ecological zones, postal districts, and so on.

Combining the lessons learned in approaching Canada in these two ways, we reach what may be assumed to be the least-common-denominator of many economists on this subject. Jurisdictions should exist to manage and foster natural resource utilisation industries. The boundaries of these jurisdictions should be drawn to bring about a correspondence between the geographical area governed by the jurisdiction and the geographical span of the effects of its management policies for each resource.

This can be a powerful criterion, and it has sometimes been applied to the search for an optimal unit for "the governance of common-property resources", such as those that transmit noise, disease, nuclear fallout, and other detriments to the enjoyment of environmental quality or privacy. It can also be applied to the management of ocean fisheries and to continuous river systems.

Unfortunately, in practice this intuitively attractive criterion has severe limitations and offers very little guidance in assigning responsibilities for natural resources. It is revealing to investigate why this is.

First, it turns out that the "natural" geographical region for mineral resources is very small. There are very few spillovers of a kind that can be dealt with by broadening the area of the political jurisdiction. While some resources will always cause problems of fumes or water pollution for residents of adjoining jurisdictions, it is probably useless to attempt to devise a system of jurisdictional borders that run through barren no-man's lands, empty of minerals or communities. The same is true of oil and gas exploitation. The natural unit of the forest resource sprawls a little more.

In general, oil, gas, metals, coal, and forestry can clearly all be managed within very small political units if necessary; contrariwise, they can also be managed easily by very large political jurisdictions.

Second, in general the internalisation criterion is weak if not wrong. This can best be understood if we think of the optimal jurisdiction question as requiring the comparison of costs of governing in jurisdictions of different

unit sizes. In these terms, the criterion is weak because it is based upon the assumption that political decisions that are taken for dealing with internal matters are costless, while those that must take the form of agreements with adjoining jurisdictions are unbearably costly. These assumptions are usually unstated, and they are not based upon scientific comparisons. It is quite conceivable that external coordination and liaison with outside jurisdictions presents a less costly – and more socially acceptable – mode of managing resource problems than the internal political alternative of dismantling boundaries and centralising policies.

A few examples follow, all stated provocatively to give credence to the idea that the present way of organizing matters, whatever the merits of the decisions and resource allocations, is a less costly means of discussion, fact-finding, and decision-making, than would be an "internalised" (one-government) system.

(i) *A redistributive matter.* The Atlantic Provinces and Quebec get oil and gas supplies from western Canada or from abroad, and tax resources to purchase them, at less real cost, in coming to agreement and remaining harmonious, than if all the arrangements were to be internalised in Ottawa without any separate voice or power in the consuming, producing, and tax-paying areas.

(ii) *A technical question.* Whether James Bay power should be used for a nuclear system rival to Candu will be compromised between Ottawa and Quebec at less cost and friction than if rival interests had to hammer it out within Ottawa without the aid of provincial-federal relations systems.

(iii) *A spillover question.* Whether the Garrison Dam project is acceptable at particular levels of compensation of abatement offered to Canadians, will be better worked out in Canada with Manitoba to represent the victims than it will in the United States, where almost all aspects of this particular question are internalised in Washington, D.C., and where the border states are powerless to state preferences about tradeoff decisions about the size or the scale of the project preferred locally.

(iv) *A marketing question.* Decision and administration costs are lowest when Saskatchewan is free to innovate in potash "pro-rationing" and nationalisation, without implications for resource marketing or ownership in Manitoba or Alberta.

(v) *A taxation question.* It is economical for B.C. to tax energy as though its producers were mostly gas producers, while Alberta, with large oil deposits, organizes royalties, ownership and taxation differently.

These examples are intended only to illustrate the approach to "cost of government". Research is necessary to discover the agreement, administration, search and set-up costs involved in alternative jurisdictional systems. Our aim is to suggest that all small governmental units, subject to spillovers and diseconomies of scale if they do not cooperate and coordinate, may well

be able to make the obvious investments in coordination and cooperation between themselves at lower social costs than would be involved in the search, administration and agreement costs within jurisdictions of larger size.

B. CAPACITY TO DEAL WITH THE PRIVATE SECTOR

In the natural resource sector, the role of government is not simply to act as a policeman among competing small firms and persons. Instead, the government is a principal, selling to and buying from independent entities outside its legal control. Its contacts are with large firms, mobile between regions, markets and products. Some are multi-national, some are owned by foreign governments. It must also cope with Wall Street and international money markets.

The government needs large amounts of information, and the capacity to out-wait, out-bluff and out-bluster organized industry groups and individual tenderers. Bargains may be embodied in laws applicable to whole industries, or in contracts with particular firms. In one way or another, they must come to agreement not only on prices and quantities, but also on timing, grade, quality, employment conditions, local hiring preference, safety, infrastructure, community development, local purchase of supplies, and so on through a long list of negotiations and decisions.

Some jurisdictions have shown themselves to be very successful in this kind of bargaining. Alberta is thought to be one of these. It has successfully unilaterally raised its royalties against world oil producers, and driven a fairly tough Syncrude bargain against the oil companies, Ontario and Ottawa. But other provinces, and Alberta in other instances, have revealed disabilities. They feel that they have been "picked off", one by one, by international industry. This view gains strength if it is assumed that it applies when the provinces are competitive suppliers and when the international industry is a discriminating monopoly buyer.

Some sort of market failure, or "government failure", is involved, suggesting at least one of the following disabilities. These may be regarded less as distortions than as sources of transactions and organization costs, varying with respect to the jurisdictional level charged with bargaining with industry. Three are worth noting.

(i) *Ability to handle risk.* In the extractive industries, large capital-intensive establishments and associated infrastructure are installed for a limited number of years. Industry may have to make decisions while the total amount and quality of resource is only roughly known. At this stage it bargains with government for tenure. Some types of resource contracts amount to a risk-sharing contract, with the government essentially taking a share along with the equity holders (e.g., an income tax). Others call for a specific payment per unit produced (a royalty). Still others call only for an initial payment (stumpage, bonus payment). The uncertainty of the government's

revenue is greatest with the first system and least with the last. The amount of revenue captured by a government depends on which of these payment systems it adopts. In effect, by the first system the government accepts a large risk and gains an opportunity for a large return. Compared with that system, under the other systems the government pays an increasingly large premium in order to avoid risk and obtain a certain flow of revenue. These are only three of the alternatives open to governments confronted with risks. The others all involve diversification of its other revenue sources, or diversification of its real and financial investments. This second group of alternatives may determine whether, in confronting business in connection with resource tenures and concessions, it is "risk averse" or "risk prone". A risk-averse government may make large price or service concessions to businesses, while governments with more diversified portfolios or with better linkages to the world insurance and capital markets, and thus not so averse to risk, could handle a similar situation more cheaply.

Economic analysis suggests that other things equal the more senior the government and thus the more individual projects within its jurisdiction, the better it will be able to deal with contractors and exploiters. Thus it may be that Ottawa can self-insure itself more cheaply than the terms open to Alberta or Quebec. If so, this would be a reason for assigning this aspect of resource management to the central government. Other economists accept the analysis but not the assumption that all governments are of equal ability and knowledge. Alberta's ability to handle risk, given her credit rating in Wall Street and her sources of information, may surpass Ottawa's. (This is not a theoretical question; the answer must be sought in financial statistics).

(ii) A closely-related question is *time preference.* Even if all levels of government could handle risk easily, some might be able to handle delay in receiving the return from their resources more easily than others. These would have a pattern of planned government spending over time that complemented that promised by a new private resource project. If all could borrow at the same interest rate on the world capital market, there would be nothing in this argument, for a government could change the actual time-pattern of its net returns by spending now and repaying later (or, depending on the pattern, lending now and spending later). Governments cannot count on either perfectly-fitting spending and natural-resource revenue patterns or such easy access to the money market as to suffer no significant difference between borrowing and lending rates. Ideally, we would wish to assign decision-making about resource exploitation rates and the resultant pattern of revenues to a governmental level that could take advantage of both conditions: i.e. one that could (a) bring about an ideal relationship between exploitation, returns and expenditures by (b) discounting future payments and compounding past revenues at an interest rate that reflected the time preference of its citizens and the available (or opportunity) rate of return on

foregone investment opportunities. This joint condition is very demanding. No jurisdictional level can satisfy it completely. Whether its partial satisfaction would point to Ottawa or to the provinces remains today simply a matter for empirical or trial-and-error question. It is not obvious that the senior governmental level would be selected.

(iii) *Associated government expenditure.* In dealing with the private sector, governments must come to understanding about who is to provide roads, terms for use of water and waste-disposal facilities, relationships with local communities or specially-constructed townsites, costs of hospitals and health care, schools and teachers, police, fire, recreation and so on. Some will already have policies on these matters; others must face every issue afresh, fearful of forgetting important stipulations, and generally of overstating their demands.

Sometimes they can hire negotiators, or borrow expertise. More important, the strength of their general bargaining position will depend on whether they are able to finance infrastructure themselves, or must, in bilateral bargaining, force industry to provide these services, outside the budget.

This suggests that a government level that is low on other natural resource revenues or general tax resources will not be able to drive an advantageous bargain. It must avoid two perils. One is finding itself over-extended in providing government services for particular frontier resource projects. The other is making excessive tax rate concessions to mining and logging firms in return for their agreement to provide their own infrastructure.

This aspect of the problem has been noticed before. In order to synchronise private and public expenditure, so that there is a common understanding about the ideal length of life of timber stands, mineral reserves, and public capital goods, there is much to be said for linking the finance of local works with the returns from resource depletion. This was recommended in a noteworthy passage by the Rowell-Sirois Commission, which suggested that mineral revenues should be used to "amortise" local projects associated with resource extraction.

But this too leads to an empirical question. Which level of government is most helpful to, most sensitive to, the decisions of oil wells, mines and sawmills? Even the Rowell-Sirois Commission recognized that it might not always, or even mainly, be the junior government. Some "local works" (wharves, post offices, highways, even some schools and hospitals) may be a national responsibility, so that natural resource revenue should be paid to Ottawa to amortise its share of resource-specific infrastructure.

The reader will notice that these three considerations are symmetrical. In its dealing with industry government can act independently, providing its own insurance against risk, its own capital, and its own infrastructure. If it is inexperienced, lacks information, or is out of touch with markets where these can be obtained, it may have to "buy" them from the companies with

which it is dealing. In such circumstances, a company may become a monopolist, charging what the traffic will bear. In these situations, economists would advise that one way of strengthening governments' bargaining positions may be to assign the matter to another governmental level. But: not always a higher level!

C. REDISTRIBUTION

The question, "Who should get natural resource revenues?" is becoming increasingly important in Canada. To whom do local resource rents belong? Economists' methods bring no particular insight to the fundamental legal and moral aspects of this question. The issue does have some economic aspects, however.

One is the effect of resource revenues on mobility. Canadians can share in the resource revenues of the richest regions if they agree to move to the region where they accrue to the provincial government. To economists this is inefficient, for instead of attracting people to areas where their productivities are highest, it only succeeds in drawing them to jurisdictions where their shares of provincial taxes or royalties on rents are highest; indeed, their personal productivities may be very low. This probability poses a policy challenge. Recognising that many people could obtain some share of provincial natural resource revenues by migrating to the most fortunate provinces, that such migration may serve no efficiency or productivity goal, and that the potential migrants are no more nor less deserving than those who are not so mobile, to what extent and in what manner should these rents be distributed nationally so as to serve both moral (ethical) and efficiency goals? The challenge may be met either by the assignment of resource revenues or by the confirming of existing federal grant or equalization measures.

These routes are not precisely equivalent. Any resource-rich province can block or veto an equalization system by *lowering* its taxes on resource rents, thus allowing these surpluses to become diffused in nation-wide profits and dividends, or, ultimately in local wages and employment. Furthermore, governments may frustrate a re-assignment of resource revenues by augmenting or reducing their own or each other's short-run natural resource revenues by fixing materials or energy prices, wage rates, rentals, or interest expenses.

In spite of these complexities, it seems clear that the challenge requires a nationally-redistributive, not a provincial or local, solution. Most Canadians today seem to agree on nation-wide redistribution of some part of economic rent. The challenge of offshore oil, Arctic gas, the tar sands, and James Bay may be to devise a formula, distinct from the equalization formula, for spreading the pure rents across Canada, in accordance with feasible and agreed criteria. The amount so redistributed should be a true surplus, not a part of some necessary payment for inputs of a local or industrial nature. This redistribution may be one of those conflict-ridden questions that a federation can deal with more efficiently than a unified nation.

7. Concluding Remarks

These notes have been based on the idea that "resource conflicts" will continue to be an important part of the Canadian political scene. The purpose of these notes has been to suggest how we may analyse our institutions in order to understand whether they are the "best" we can utilise for dealing with future issues and crises.

We begin with the assumption that we are going to remain with a federal system of government; that there is no chance of decentralising down to Balkan status, or of centralising to uni-government structure.

The previous long section has dealt with the questions which one would wish to resolve in order to decide whether resource questions should be, in the main, moved downward to lower levels and smaller governments, or upward to higher and larger jurisdictions. This exercise was inconclusive, because there is no reason to believe that greater efficiency in management, any saving in government costs or any superiority in capturing rents from the private sector would emerge from any radical reassignment of natural resource revenues or resource regulation functions.

At the very end we did bring in the idea of redistribution. A majority of Canadians, probably, would reject the idea that resource revenues ought not to be spread around the country – most would accept continuation of the vague policy that these windfall gains should go to all. This alone seems to be a strong criterion for future action. For if natural resource revenues capture rent, then they must not be too far from the control of those who would redistribute nationally. And if the collection of natural resource revenues is also a management tool, then there must be some legal connection between those who manage and those who collect. And finally if there are many reasons for managing resources locally, it follows there must be a continuation of "conflict", or a coordination of local management and national collection of some share of the natural resource revenues.

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Interregional Economic Barriers: The Canadian Provinces

Carl S. Shoup

This is primarily a theoretical discussion of the barriers to Canadian interprovincial trade that are posed by different kinds of taxes, by marketing boards, by government procurement policies, and by a number of other non-tariff barriers. The paper goes on to speculate on the consequences for interprovincial economic flows that might arise if provinces were to gain greater powers over taxation, internal customs duties and the money supply.

I. Introduction

This paper outlines some of the economic barriers that do, or might, exist between the Canadian provinces under the present intergovernmental structure. It also discusses the question: if one or more of the provinces obtained more control over their economic environment through greater decentralization, what might happen with respect to economic barriers among them? In what ways, if at all, might existing restraints to interprovincial trade be increased? Would such increases prove important? Could the mobility of labor and capital be significantly impaired?

Some provinces are, speaking broadly, poor, and some, rich; some produce a wide variety of finished products, others chiefly farm products and raw materials for further processing; some are populous, others are not.

These combinations cut across one another. Which of the varied types of province might stand to gain by measures taken under further decentralization? Which to lose?

No quantitative answers, of course, can be given to these questions here. The first step, attempted in this paper, is to list the chief possibilities and conjecture what might be the consequences. It may then be possible to say whether interregional economic barriers do or do not merit a heavy weighting among the pros and cons of decentralization.

The term "barriers" is used here in a broad sense, to include restrictions that reduce, without eliminating, trade and mobility, and even measures that artificially stimulate certain economic currents. First, these barriers might be thought of as preventing the flows of goods and services, and of labor and capital, from being as they would be in the absence of the provincial economic measures, whether restrictive or stimulative. Second, the chief measures are in fact likely, as will become apparent, to reduce trade, not to expand it, and to reduce mobility also. The present paper is devoted largely to the restrictive types of provincial action.

The answers depend on the degree of decentralization that is assumed.

The first type of decentralization to be covered is that of the existing system (Section II), and it makes up the bulk of the paper, as a necessary starting point for appraising more intense degrees of decentralization. It considers the question: under the present distribution of governmental powers, what barriers to trade and factor movements do, or can, the provinces impose? It would take an extensive study to construct a reliable listing of the barriers that in fact exist, and their relative importance. Some examples can be given, however, and some remarks are offered on relative importance.

The next section (III) assumes one major step toward further decentralization: the provinces, through recontracting or through changes in the constitution, are given freedom to create whatever kinds of tax systems they wish, provided only that they impose no customs duties or export taxes or subsidies for traded goods. Greater regulatory powers on grounds of health, sanitation, and so on might also be assumed for this initial step, since regulation, rather than fiscal measures, may well form the chief barriers; but it is impracticable for the present paper to construct a series of ever greater regulatory powers: this concept needs a study of its own.

Section IV considers the consequences under a more radical assumption, namely, that each province could impose whatever customs duties it desired, upon imports from and exports to other provinces – but not on goods moving from the province directly to other countries, or on imports therefrom.

Section V works with the still more radical assumption that one or more provinces could create their own currency, to circulate in the province either alone or concurrently with a national currency. Here, groupings of provinces

into regions must be considered, as in aiming for "optimal currency areas."

Section VI assumes, in addition, freedom to levy customs duties on goods from other provinces or from other countries, and raises the question whether, under these freedoms, the then "provinces" might try to recombine somewhat in the form of a free trade area or a common market. A final Section VII offers some tentative conclusions.

All this, of course, is the reverse of what has been occurring in Europe, under the European Free Trade Association (EFTA) and the European Economic Community (EEC). Developments there can be studied in reverse, as it were, and several references will be made to their experience.

II. Barriers Under Existing Systems

A. BROAD-BASED TAXES

(1) *General Sales Taxes Levied by Provinces*

The retail sales taxes levied by Canadian provinces are not barriers to interregional trade. Imports from other provinces are indeed taxed, although not at the border, but in the retail store where they are sold to the final buyer. But so too, of course, are goods produced within the province, and sold there. No distinction is made between these goods of different geographical origin, when they are sold at retail.

Moreover, this neutral treatment is preserved, at least in principle, when a consumer buys direct from a seller in some other province. The consumer is supposed to pay the sales tax to the government himself, or perhaps the province can persuade the out-of-province seller to collect and transmit the tax money. In so far as this is not done, an artificial stimulation of inter-provincial trade occurs, but the amounts involved are probably slight in relation to total trade.

The tax at retail has the great advantage of requiring no border controls, no customs-like machinery, to enforce neutral treatment as between imports and home products. Imports get taxed, eventually; and exports, since they skip the retail stage, are automatically exempt. For any particular out-of-province product, no matter where it is produced, the tax rate that hits it is the rate in force in the province to which it is sent for final purchase, its destination province. It is therefore said to be a "destination-principle" type of sales tax. The reverse type of sales tax would exempt imports but tax exports; it would be an "origin-principle" type of tax. With rare exceptions, it has never been employed in any country.

Differences in the rates of the retail sales tax among provinces likewise represent no barrier to interprovincial trade.

Flows of capital and perhaps of labor, as distinguished from flows of goods, may be somewhat affected by the retail sales tax, if the word "retail" is taken to include, as it often is in tax legislation, sales of all "final" products, not just to consumers but also to producers. For example, a certain province may tax the sale of a printing press to a printing shop. This misapplication of the "retail" concept can make it more difficult for capital in that industry to earn a normal profit than in a province that does not so extend the meaning of "retail." The variation among provinces on this score may not be great enough to affect the total flow of capital appreciably, however.

Effects on the interprovincial flow of labor would be even less, since the effect would be indirect, i.e., it would be consequent upon the distortion of the flow of capital and the resulting geographical change in the demand for labor to work with the capital equipment.

(2) *Corporate Income Tax*

A corporate income tax is no barrier to trade, however much it may affect the flow of capital and labor. This conclusion assumes that the corporation does not raise its selling prices directly because of this tax. It may reduce its output, moving some of its capital elsewhere; then, as consumers bid for the reduced output, prices may rise somewhat, so one cannot say that there is no price effect at all. Moreover, some economists and many business spokesmen assert that corporations do directly raise their prices when the corporation income tax rate goes up. The evidence is inconclusive.

If indeed the corporate income tax is directly reflected in higher selling prices, a provincial tax of this sort is just the opposite of a general sales tax, as far as interprovincial trade is concerned. Imports are exempt. Exports are taxed. The corporate income tax is therefore levied on the "origin principle." (Imports are exempt in the sense that the profit element already embodied in the import value of the good is not taxed by the province of entry.)

Imported goods, under those suppositions, have a tax advantage over domestically produced goods, whether for sale internally or for export. In a country with its own currency, this feature amounts to an appreciation in the value of that currency. The resulting internal pressures on prices might well force, eventually, a formal devaluation of the currency. No such mechanism for relieving internal pressures and strains, e.g., unemployment, is available to a common-currency area. The adjustments in the provinces within that area would have to occur by the fall in domestic demand causing unemployment and thereby putting a downward pressure on wage rates and prices. This train of thought will not be pursued here, because of the dubious nature of the assumption of direct reflection of the corporate income tax in prices. Moreover, for interprovincial trade, it is the differences in the provincial corporate tax rates that are decisive, and on these grounds there appears

to be no likelihood of substantial trade impairment, even under the price assumption employed in this paragraph.

In passing, it may be noted that for international trade, as suggested in the paragraph above, that is, trade among countries each with its own currency, it makes no difference, in principle, whether a broad-based tax is levied on the destination principle or the origin principle, since the exchange rates will be forced to adjust, to yield the same trade results in either case. This conclusion is subject to certain assumptions about initial trade equilibrium, absence of transfer of transfer payments, and the like (Shoup, 1953, 91-93; Shibata, 1967, 194-206). If the Canadian provinces each were to issue their own currencies, the conclusions reached in the present section would have to be restated accordingly.

The absence of any substantial discussion of these interregional trade issues in the United States over the past few decades with respect to state sales taxes and corporate income taxes is instructive. It seems to confirm the inference given above, that the trade-restricting effects are of little importance. Or perhaps it merely means that the states have for some time had no real trade-off available: almost all of them have been levying both retail sales taxes and (in a lesser number) corporate income taxes.

(3) *Individual Income Tax*

In so far as the individual income tax strikes the profits of unincorporated enterprises, the analysis in (2) above applies. As to dividends and interest, the tax has no direct effect on interregional trade, but substantial differences in provincial tax rates could affect the residential choices of investors, perhaps only mildly. No regional effect on investment need be expected.

Earned income is a different matter: highly paid executive talent may be reluctant to live and work in a region with exceptionally high individual income tax rates, and this fact may affect decisions as to where the firm itself is to be located, or where it is to expand. The effects on trade would be indirect; those on employment, direct. Less mobility may be assumed for the lower earned income recipients, and the tax rates will be lower too. All in all, freedom of the provinces to levy any kind or any rates of individual income tax seems not in practice to be important in the present context.

(4) *Property Tax*

The property tax, chiefly a real estate tax, will exert no direct effects on interregional trade. It will, however, aside from the part imposed on land, affect the allocation of investment among the provinces, unless offset by similar variations in levels of government services to business. Differences in the rate of tax may then be thought of, in a restricted sense, as indirect barriers to trade.

(5) *Social Security Taxes*

If each province had its own social security system (instead of just one province, as at present), there still might be little effect on workers' decisions where to locate and where to retire to, if the rates and benefits were not greatly different, and if the benefits were not contingent on the retiree's residing in the province where he made his contributions. But the real possibility of such divergences and restrictions growing up under provincial autonomy in this field is a sobering thought; the present writer intuitively feels that, of all parts of the fiscal structure, the social security system for old age (if not for other purposes) must be a central-government function if social tension and geographically devisive tendencies are to be minimized.

B. NARROW-BASED TAXES

(1) *Excises*

Regional excise taxes diminish somewhat the feeling of oneness that a common market is supposed to create. The EEC has found no solution to the problems posed by the facts that (a) the regions (here, countries) differ widely in what they regard as proper rates of tax on alcohol, tobacco, and motor fuel, to name the more important, and (b) excises are always levied on the destination principle, the object being to deter, or at least draw revenue from, consumption of these articles within the region's borders.

Border controls are therefore necessary on this score, even though customs duties no longer exist. Some such controls would therefore remain necessary even if the EEC succeeded in getting all the value-added tax rates to about the same level and then moved that tax to the origin principle, so that no further border checks would be needed for the VAT itself.

In some countries, excises levied at different rates by sub-country jurisdictions have engendered a good deal of cooperation among the tax officials of those sub-areas, e.g., the attempts by North Carolina and New York State tax officials to check bootlegging of cigarettes from the former, low-rate state into the latter, high-rate state. But at the political and consumer levels these differing sub-area excises remain divisive, and of course directly impede legitimate interregional trade: North Carolina (as well as other cigarette producing states) would sell more cigarettes to New York smokers if the latter state would lower its excise on this article.

The point here is that a particular region (province, or state), by levying a heavy tax on the consumption of a particular product, may be in fact imposing what amounts to an import duty, when that product happens to be produced only in some other region or regions.

A negative excise tax, that is, a subsidy, on the production or sale of a particular article will distort interregional trade if it is given on production within the region, not consumption, i.e., on an origin basis. Exports of the

article from this region will receive the subsidy, but imports will not. Whether very much of this is occurring at present is not known to the present writer. On the international level it is of course one of the chief problems that the GATT was set up to deal with.

(2) *Extractive Industries*

Provinces or states blessed by major deposits of iron ore, petroleum, precious metals, etc., usually impose special taxes of some sort on the extraction, movement, or sale of these products.

The physical volume sold in any given period may be appreciably affected by the form this levy takes, that is, according to whether it is on profits, physical units of output, shipments, money sales volume, or is a royalty (ad valorem or specific), or takes the form of government participation in output or profits. If the physical volume is affected, interregional trade is almost surely reduced, since all or a large part of these products are commonly shipped across provincial lines. These taxes, royalties, or participations naturally differ as to their effects on output (Shoup, 1972, and sources there cited).

With these products, the chief strain on cohesiveness of a federation arises not so much through interregional disputes as through struggles between the region of deposits and the overlying federal government: witness the recent disputes in Canada between some of the western provinces and the federal government, and the current demand by Scotland for a special share in North Sea Oil. The EEC itself may yet encounter this problem, as its own supranational revenue raising powers are destined to increase appreciably over the next decade.

Further freedom to the province of deposit to do as it wishes would benefit chiefly, in Canada, provinces that are less populous, less variegated economically, but rich (e.g., Alberta). If the province is not rich, the equalization formula means that it benefits less from resource taxation of its own.

C. MARKETING BOARDS

In 1972 there were about 172 provincial farm marketing boards in Canada, involved in the sale of about one-fourth, by value, of the total of Canadian farm products (Federal Task Force on Agriculture, 1972 [henceforth "FTF"], 311). Such a board has compulsory powers over all producers, within the province, of a specified commodity, usually through enforcement of a two-price system, collective bargaining with purchasers, or input quotas or sales quotas for individual farms. The aim is always to increase the net income of the province's farms producing the commodity in question (FTF, 312).

The two-price system allows the board, after purchasing from the farms, to sell at a higher price in one market than in another: wheat is sold at a lower price when exported outside of Canada. Alternatively, it may allow the board to charge more for use in one form than in another (milk for fluid consumption is sold at a higher price than milk for industrial use).

The two-price system would appear, for obvious reasons, to cause no difference in prices among provinces, given the freedom of the commodity, once sold by the board, to circulate anywhere in Canada, save for health and sanitation restrictions noted below. The second price is, then, the price for export outside of Canada (FTF, 314).

"Provincial marketing boards have often found the effectiveness of their programs undermined by increased production and lower prices in other provinces" (FTF, 319). The word "often" in place of "always" suggests that in some cases a provincial board does in fact succeed in increasing the price of its product in one or more other provinces. Since a higher price means less sold, there is in these instances a restriction of interprovincial trade. But the tone and contents of the Report of the Federal Task Force on Agriculture (1972) imply that differences in price of a commodity from province to province traceable to action by marketing boards are not, on the whole, important. This seems to be so, even if the difference takes the form of "dumping," that is, selling the product at a lower price in some other province. On the other hand, there are examples of a province's restricting entry of a farm commodity by standards of health or sanitation that in effect discriminate against products from other provinces; these are described in Section III below, in E, (2). This action is of course taken by the provincial government, not by the marketing boards.

Potentially, this multiplicity of marketing boards, province by province and commodity by commodity, seems a threat to a free-movement market within Canada, a potential source of barriers and interprovincial friction, but evidently the history of the boards so far does not give great cause for concern on this score.

D. GOVERNMENT PURCHASING POLICIES (PROCUREMENT)

At the national level, government departments commonly discriminate against firms in foreign countries when buying supplies on a routine basis or when letting contracts. The foreign supplier may be frozen out even when he tenders at a lower price, with all other things equal. Where this practice exists, it is usually dictated to the department by national laws, decrees, or administrative orders.

The question arises, do — or might — provinces or states within a nation follow similar practices, discriminating not just against foreign-country suppliers but also against domestic suppliers in other provinces?

No general study seems to have been made anywhere on this point. An instructive list of possibilities can be drawn up, however, by noting what national governments have done, and asking, which of these discriminatory practices are applicable to within-country jurisdictions? (Defense expenditure, for example, and the discriminatory policies there followed, are clearly not applicable at the provincial or state level, at least for the "big ticket" items.) Most of the factual material in the present sub-section is therefore drawn from a study of national practices: Baldwin (1970), Chapter Three, "Restrictions on Governmental Expenditures."

Such restrictions, if applied by provincial governments, diminish interregional trade, obviously, just as on the national level they impair international trade. The EEC Commission considers these buy-local practices "substantial impediments to trade between Member States." (Smit and Herzog, 1976, Vol. I, 2-130).

These practices, however, do not diminish interarea trade by as much as the data on government procurement policies might initially suggest. Indeed, the result might conceivably, in an extreme case noted below, be an increase in such trade. When the government buys, say, automobiles at home rather than abroad, it will still be buying a substantial part of the automobile from abroad, if the domestic seller is only an assembler who imports most of the car's components – perhaps from the country where would-be vendors were rebuffed. (Some of the national governments take this possibility into account by specifying, in their buy-at-home rules, a minimum domestic content.)

In an extreme case, a government might (a) if it bought abroad, get something most of the value of which had been added right in the purchasing country, the foreign vendor depending heavily on this country for components, while (b) if it bought locally, its vendor might be of the assembler type noted above.

These roundabout effects may not be very important as between nations;[1] but among provinces or states within a country, the indirect effects could easily be stronger than on the international level, and could make the discriminatory procurement policy far less effective than would at first appear. This would tend to be the case, especially, for an undiversified province, perhaps rich in oil or minerals, which must in fact import a good deal of what it consumes, no matter whether the vendor is within or outside of the province.

At the other extreme, these indirect effects might be largely disregarded by a highly diversified province. But in this case, a discriminatory policy to promote domestic procurement would be correspondingly less necessary to guarantee purchase within the province.

[1] Baldwin (1970) touches on them, in computing the import-reducing effect of United States discrimination for the year 1958 (p. 71, note 21), and in discussing French practice (p. 75).

Under discriminatory procurement policies, interregional trade within a federated country will therefore tend to be both greater and less, on that account, than at the international level: greater, as between highly disparate provinces, economically; less, as between two provinces both fairly well diversified. To be sure, even on the international level, country-country disparities can easily be large enough to make the statement above valid only in a general sense (one thinks of Saudi Arabia, for instance).

Quite apart from these indirect, "leakage," effects, regional governments will normally prove to be less discriminatory on this score (government procurement) than national governments, for four reasons.

First, military procurement is usually the largest part of a national government's goods-and-services expenditures (as contrasted with transfer payments). These are often made at home for security reasons.

Second, balance-of-payments pressures are a chief force in deciding national governments to buy at home. In a province within a common currency area, in contrast, an overvalued currency cannot even exist, much less be a problem.

Third, nationalized industries are often restricted to buying within the country. A province or state is likely to have a smaller proportion of total governmental purchases made through such industries than are most national governments. This may not be so, however, in Canada, in view of the many provincial corporations.

Fourth, a region commonly does not grant aid directly to another region, and so does not have an opportunity to tie that aid to purchases by the other government from firms within the region.[2]

The chief discriminatory procurement techniques are:

(1) A deliberate, generalized, buy-at-home policy, as in the United States under the so-called Buy-American Act of 1933, instigated initially to combat heavy unemployment.[3]

(2) Selective tender or single tender in place of public tender; only particular selected suppliers, or just one supplier, are, or is, allowed to bid on the contract. Automatic tender may, under certain circumstances, lead generally to local purchase; this is where the tender rules call for automatic acceptance, usually on a lowest-price basis, as against discretionary acceptance or negotiated acceptance, where the awarding authority negotiates the conditions of the contract quite freely with the supplier. Under other circumstances, discretionary tender will be the one to guarantee local purchase.

(3) Inadequate publicity of information on bidding opportunities.

(4) Inadequately detailed information on types and quantities of goods desired, value involved, deadline date for submission of bid, and address for further information.

[2]For aid tied internationally, see Baldwin (1970, 81-83).

[3]For details, see Baldwin (1970, 67-78).

(5) Short time limit for submission of bids.

(6) Technical requirements for the product that only domestic suppliers can meet, or that exclude techniques that are used more by extra-regional producers than by those at home.

(7) Residence requirement for vendor.

(8) Information required of a type that is more easily supplied or more readily accepted if from within-region sources: bank guarantees, other evidence of financial stability, ability to carry out a contract.

(9) Authority to purchase foreign exchange exceeding a certain amount required from the central bank, exchange control authority, or the like.

(10) Disregard of price differences within say 5 to even 50 per cent if the vendor is a domestic business that is small or medium-sized, or that is a cooperative, or that is located in a depressed area, or that is engaged in an "infant industry" deemed especially promising for development.

(11) Failure to disclose information on bids that were submitted (such disclosure, after the award, helps the losing firms prepare for the next bid, and is especially useful to "foreign" bidders).

All of these discriminatory techniques, except No. 9, seem about as equally available for provincial bidding as for national-government bidding.

A rather different issue is a policy of a province or a state discriminating against foreign-country suppliers, but not against suppliers in other provinces or states within the country. In 1970 Baldwin reported that more than twenty United States states and many local governments were discriminating in this manner, although the United States courts have "looked unfavorably on state buy-American acts" (Baldwin, 1970, 68).

Research at the international level, now under way, may soon provide insights applicable to regional procurement discrimination. Baldwin (1970, 59) noted that "the OECD meetings on procurement have proceeded to the point where various guideline proposals are now under discussion." Apparently, however, the OECD has not yet published such guidelines.

As to what type of province gains, if any, and what type loses, if regional procurement discrimination is adopted by the province, there seems no ready generalization at hand. Perhaps the province that loses the most by adopting this policy is an undiversified province that is also poor, and not very populous. Even under its discriminatory policy, it will be importing most of the content of what it buys from its favored, local, vendors, for reasons given above, and it will be importing the hard way – through inefficient end-sellers who create little economic activity in the province and who operate at a higher cost than out-of-province dealers. Not being very populous, the province cannot look to this policy to create its own local industries to supply the earlier stages of the value-added after a number of years. And being poor, it can ill afford the extra cost that goes with buying

locally. A rich province may be willing to accept this waste in return for the psychological satisfaction of appearing (wrongly) more self-sufficient. The only instance where this policy might do some good over the long run is that of the populous but poor province that has definite plans to industrialize, and good reasons for thinking that it can do so, eventually, at not too high a cost. Even there the economic case for regional procurement discrimination seems dubious.

E. NON-TARIFF BARRIERS

A host of measures, chiefly regulatory, and not connected with the government's expenditures and revenues, may affect interregional trade appreciably. Some of them are clearly designed to do so; many, if not most, seem on their face to have nothing to do with such trade, though trade may have been the chief consideration. These measures are commonly called "non-tariff barriers". The term can include specific border-crossing regulations, but this type of non-tariff barrier is usually not available to a province or state, with the exception of certain health and safety regulations. Discriminatory procurement policies, border tax adjustments, and subsidies, already discussed above, are sometimes included in non-tariff barriers.

The number of distinct non-tariff barriers is legion, owing largely to the fact that "the significant non-tariff trade measures are usually politically motivated. These political motivations may relate to specific towns or regions, or groups of workers, or international ties, or vocal consumer interests, or national technological objectives, and so on" (Malmgren, 1973, 87). If we substitute "interprovincial" for "international", and "provincial" for "national", the statement probably applies quite well to Canada or (substituting "states") the United States.

The particular non-tariff barriers, aside from those already covered in previous sections, that appear to be most commonly listed in the literature on this subject are given below. But this literature, it will be recalled, is almost entirely devoted to such barriers between nations. The possibility of using them within a country must be considered case by case.

1. *Right of establishment, or right of entry into a business, or right to practice a profession.* The laws or regulations on such rights may be slanted against newcomers from other jurisdictions, thus impeding the flow of skills, if not of trade.

2. *Standards set for safety or health.* These standards, though applicable equally to domestic and "foreign" products, may be so drawn as to favor local labor, or products produced at home. "For example if Province B insists that milk sold in the province must be produced on farms which are inspected by Province B's inspectors, and these do not visit farms in Province A, then there can be no interprovincial movement from A to B. Similarly if a province insists that eggs must be inspected and check graded by its own

employees, perhaps to slightly different specifications from other provinces, then that province can so harass importers that interprovincial trade is reduced." (Federal Task Force on Agriculture, 1972, 319).

3. *Discriminatory pricing in transportation.* National governments, either through their ownership of railroads and other carriers, or through regulatory bodies, often require that freight rates be structured to favor certain regions, which means, of course, to disadvantage others, and, with respect to the latter areas, implies a barrier to trade. In Italy, for example, the transportation structure has supported southern industrial development, and "The principal weapon of German regional policy has traditionally been transportation differentiation." (Bird, 1968a, 203, 206).

4. *Discriminatory Rejection of Advertising.* If a government-owned radio or television station rejects or limits commercials that advertise out-of-region (province, state, nation) products, it tends thereby to reduce trade. In the EEC, the Italian government's broadcasting monopoly was required to cease such practices (Smit and Herzog, 1976, Vol. I, 1-59 and 1-60).

5. *Contract and Litigation Rules.* In the EEC, the common market is somewhat impaired by, for instance, the Italian rule whereby "in most instances capacity to contract depends on the law of the parties' nationality," leading to non-uniformity of treatment and possible discouragement of movement of persons or of goods (Smit and Herzog, 1976, Vol. I, 1-61).

6. *Purchase and Sales Policies of Government Monopolies.* Government monopolies that are not fiscal monopolies handling liquor, tobacco, or petroleum, may nevertheless affect interjurisdictional trade by their purchasing and selling policies. This issue differs from that of discriminatory procurement noted above in that the purchases there were, for the most part, by government departments that did not resell. The combined purchase-sale discriminations have been a source of difficulty in the EEC (Smit and Herzog, 1976, Vol. I, 2-161 ff.).

7. *Technological Safety and Health Standards.* The technological safety and health standards set by many governments could be included in No. 2 above even where they are quite technologically oriented, but it may be more useful to consider them separately. Examples in the United States are: (a) the New York City building code prohibits pre-wired electrical installations, a provision said by its critics to be only a device for protecting jobs of local electrical workers; (b) the stiff anti-emission standards of California for motor vehicles, which may hamper trade with Michigan and other automobile producing states. At the international level there may be cited the "French regulations prohibiting the advertising of spirits distilled from grain (but not from fruit) on health grounds" (Baldwin, 1970, 145), and the fact that "In 1955...one basic Volkswagen model could be exported anywhere in Europe whereas now nine to ten variations of the basic model are needed to satisfy the different safety standards." (Baldwin, 1970, 145).

Although this small sample of non-tariff barriers may not be representative, it does suggest that if they were applied by provinces or states they would be found in those that produce a variety of finished products. At least this is so with respect to the regulations that specify something about the structure or composition of a consumer's good, or the inspection process for such goods (eggs, milk), and for finished producer goods, say a machine. There seem to be few regulations specifying, for example, the composition of a coal shipment or the quality of iron ore or grain.

To this extent, these barriers operate to the disadvantage, not of the materials-producing provinces, but of the diversified producing provinces that seek markets in other diversified provinces, where the protectionist sentiment that sometimes engenders these rules will be flourishing. The division of advantage-disadvantage here thus seems to be along lines other than rich and poor, or populous and less populous. Some of the barriers are of course not assessable along these lines (right of establishment, contract and litigation conflicts).

III. Barriers Under Expanded Taxing Powers (excluding tariff duties)

This section can be brief, since few if any additional barriers could be erected if the provinces were granted full autonomy in taxation, that is, the ability to impose indirect taxes now prohibited by the BNA act. (The provinces would still have no power to impose customs duties or their equivalent.)

The provinces could then impose general sales taxes at levels above the retail stage, including a value-added tax. Border control might be introduced, but the barriers to interprovincial trade would not on that account be greater; the tax that used to be collected entirely at the retail stage would now be collected in whole or in part at one or more earlier stages.

Compliance costs to business firms, however, would rise, owing to the paper work generated by border control. In fact, in general it seems likely that one of the prices of decentralization, in whatever form, would be an increase in cost of compliance with the tax laws and regulations, not to mention compliance with non-tax regulatory measures.

Border control might be avoided under provincial value-added taxes if those taxes were levied on the origin principle (no exemption granted to exports; imports taxed only on value-added within the importing province). Without going into too much technical detail here, it may be noted that, to insure that imports would not be double taxed, the simple technique now used in European value added taxes[4] would have to be replaced by a tax

[4]The selling firm computes a tentative tax by applying the VAT rate to its *sales;* it then subtracts the sum of all the VAT taxes noted on its *purchase* invoices, and the remainder is the tax due by this firm.

levied directly on value added by the firm, or a device would have to be developed for crediting, against the tentative tax on resale within the importing province, tax already paid to another province, the exporting province. The change to an origin basis would produce quite a different distribution of the sales tax revenue among the provinces from that which would obtain under a retail sales tax, or a value-added tax on a destination basis. Raw materials producing provinces, for example, with a relatively small consumers-retail sector, would gain, as the tax would apply to provincial exports and not to provincial imports.

The non-tariff barriers available to the provinces would presumably remain unchanged. Along with the expansion of the provinces' taxing powers there might, somehow or other, be spelled out an extension of their regulatory powers; if so, the number of such barriers might be expected to increase, with consequent diminution of inter-provincial trade.

IV. Barriers Under Inter-Provincial Tariffs (but no provincial tariffs on imports from other countries)

Let us consider, if only as a prelude to more realistic sets of assumptions, what would happen if all provinces in Canada were empowered to levy customs duties on goods originating in any other province, but were still forbidden to impose tariffs on goods from other countries.

No such pattern of power to impose tariff duties now exists anywhere, to the writer's knowledge, so the remarks below must be highly conjectural.

Attempts would probably be made at once by the provinces to encourage local industry by a rash of would-be import-substituting duties. In practice, the height of the barriers thus raised would be limited, in some cases at very low levels, by the following considerations.

First, there is the case of goods already being imported from other countries, especially the United States, despite the national tariff. A customs duty imposed by Province A against entry of goods of this type from other provinces would raise the cost of such imports, relative to imports from abroad. This would give Province A's buyers a motive to purchase a larger share, perhaps all, of the good from abroad.

Much would depend on whether foreign suppliers could supply additional amounts at little or no rise in price. If they could not, price in Province A would rise, as presumed above, and some modest stimulation would be given to produce the good (or more of it) within the province. The stimulation would be modest, because, in the usual case, a modest rise in price would be all that the out-of-Canada suppliers would need to allow them to expand their exports to the province by a large amount. Hence, a high level of protection and vigorous stimulation to the provincial industry

could not be expected under these circumstances, nor would the province gain much revenue from its duties.

The same remarks would apply to an article not at present being imported from abroad, but ready to be, upon a slight rise in the selling price.

With respect to transport by land, it may be noted that all Canadian provinces save two are contiguous to the United States.

The national government's customs revenue would increase, as more goods were imported from abroad rather than from one province to another, but Canada's balance of trade would thereby worsen. On these points the national government would have put itself somewhat at the mercy of the provinces' developmental or mercantilistic policies.

Second, this power to levy inter-provincial duties might well be accompanied by a federally imposed most-favored-province rule, and this, too, would tend to keep the average provincial tariff rate down.

Third, since a common currency would continue throughout the provinces, there would be no temptation for any one province to help sustain an overvalued currency by import duties (or by export subsides).

V. Separate Currency Regions Within Canada

Decentralization at its most intense would be attained by allowing, in addition to the provisions described above, the issuance of distinct provincial currencies. The central government would still control the tariff duties on goods from abroad. But each province would possess its own central bank. Let us suppose that a national currency would circulate along with the provincial currencies. Floating or fixed exchange rates would exist among all these currencies.

Again, there seems to be no experience elsewhere to draw upon for this peculiar arrangement. Two reasons for considering it at all are that (1) some two or more provinces might argue that they would constitute an "optimal currency area"[5] (in which case those provinces would join to have a common currency), or indeed one province might argue that it constituted an optimal currency area by itself, and (2) Quebec separatism might conceivably, though perhaps not likely, develop thus far and no farther, that is, it would be still within a single national tariff wall against the rest of the world (the common market idea) and its currency would co-exist with a national currency (a modified form of monetary union).

[5] An optimal currency area is one within which major objectives of economic policy can be attained without devaluation or revaluation of a currency because, say, labor is sufficiently mobile within this area to iron out wage differentials and rate-of-unemployment discrepancies. Then, only one currency is deemed necessary for that area. A lively discussion of the tests for optimality of a currency area has developed (Ishiyama, 1975).

For present purposes, however, the important point is that the natural restraints on raising barriers to interprovincial trade through the use of tariffs (Section IV above) would be greatly weakened by the existence of separate provincial currencies. Devaluation of a province's currency vis-à-vis, say, the United States dollar would be a rough substitute for the power, not granted, of imposing a set of provincial tariff rates against goods from abroad.

VI. A Canadian Free Trade Area? Common Market?

Once one or more of the provinces obtained independent currencies and full power to levy customs duties on goods whatever their origin (in contrast to the suppositions above), a likely consequence would be an attempt to construct either a free trade area or a common market within the boundaries of present-day Canada.

For example, Quebec, if independent, might seek such an accommodation.

A free trade area allows each member to levy whatever tariff duties it desires on goods imported from the rest of the world; within the free trade area, however, tariffs, or their equivalent, on goods imported from other jurisdictions within this area are imposed only to prevent a low outside-world tariff of one of the member countries from undermining a high tariff on the same good by another member country. This undermining could occur by roundabout importation. For example, instead of direct importation from the rest of the world into high-tariff Member country A, there would be first a shipment to Member country B that imposed a low outside-world tariff, then tariff-free forwarding from B to A. This problem is not encountered in a common market, where the member countries agree on a single set of import duties applicable to imports from the rest of the world into any of the member countries.

In either instance, the problem of non-tariff barriers would assume added importance. The differing currencies would give rise to balance-of-payments pressures that would incite the member states to exercise their ingenuity to hamper imports from each other by methods not forbidden in so many words in the treaty for the free trade area or the common market (Smit and Herzog, 1976, *passim*).

VII. Some Concluding Remarks

The general impression gained by the present somewhat distant observer of the Canadian scene is that

(1) the existing non-tariff barriers are certainly of more significance than the tax barriers, and probably overshadow the provinces' discriminatory procurement policies, though on the latter point almost no factual information is at hand;

(2) further decentralization would not lead to a substantial increase in the barriers until inter-provincial customs duty powers were granted, and even then the barriers that would in fact be erected might be less than initially presumed;

(3) under separate provincial currencies, formidable barriers might easily arise, even though no province was allowed to impose duties on goods from other countries;

(4) the final economic step of permitting customs duties against the rest of the world would open such dismaying prospects of trade restriction that the former "provinces", now virtually sovereign, at least economically, would seek to retrace their steps some distance by forming a free trade area or a common market.

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Restrictions on the Interprovincial Mobility of Resources: Goods, Capital and Labour

An Illustrative Survey

Michael J. Trebilcock, Gordon Kaiser *and*
J. Robert S. Prichard;

assisted by

John Findlay, Peter Shiroky *and*
Charles Taylor

This paper provides a number of examples of the existing barriers to mobility of goods, capital and labour within Canada. The paper concentrates on government regulation of product marketing, corporations, land ownership and the professions. The barriers posed by the social and income security and higher education systems are also discussed.

I. General Introduction

Our terms of reference required us to undertake a descriptive survey of interprovincial restrictions on the mobility of resources. We have examined such restrictions in three contexts: goods, capital and labour. In each category we have attempted to do no more than illustrate, by way of three or four examples, the kinds of restrictions that reduce the interprovincial mobility of factors. In addition, we have included a brief section dealing with the question of uniformity of legislation.

This survey does not purport to be either comprehensive or analytical; its purpose is to provide representative examples that might be fruitfully incorporated into, and inform, a broader analytical inquiry.

II. Goods

1. INTRODUCTION

This section of the survey examines legislation and policies creating restrictions on the interprovincial mobility of goods. Four examples are considered: (1) wine marketing, (2) egg marketing, (3) provincial purchasing policies and (4) transportation regulation. The first two examples are particularly instructive because product marketing boards established by provincial governments control the flow of a wide variety of goods and represent perhaps the most important barrier to interprovincial trade. Provincial purchasing policies directing that preference be given to goods produced in the province could, if they became widespread, create substantial barriers to the interprovincial mobility of goods. Finally, transportation regulation is an important area of study because transportation is, of course, the vehicle for much of the trade in goods between provinces.

2. WINE MARKETING

The alleged discrimination between imported and Canadian wines is well-documented (Jaglowitz and Mador, 1974), but the barriers to the flow of wine and liquor between provinces in Canada are generally not appreciated. One of the clearest examples exists in the regulations enacted by the British Columbia government pursuant to the *Government Liquor Act*. The regulations provide that:

> "To maintain previous procedures of establishing selling prices in the liquor stores, the price at which liquor shall be sold in Government Liquor Stores shall be that price that is the total obtained by adding the cost of the liquor, as delivered to the Liquor Distribution Branch, to a markup which equals the following percentages of the selling price of the liquor adjusted to the nearest five cents."

The preference to be accorded to the British Columbia products is evident in the following table of specified markups:

PRODUCT	*British Columbia*	*Other Canadian*	*Other British Commonwealth*	*Other Countries*
Spirits	50%	50%	53%	55%
Liquors	44%	50%	53%	55%
Fortified Wine	44%	50%	53%	55%
Table Wine	40%	50%	53%	54%

On the basis of the foregoing schedule of markups, the delivery of wine by a British Columbia winery and an Ontario winery to the Liquor Distribution

Branch at identical prices, $2.00 per bottle, will result in the Ontario wine being sold in British Columbia at $4.00, while the British Columbia wine would be sold at $3.35. The magnitude of the differential results from the fact that the British Columbia markup is not the traditional percentage of laid-in cost, but rather a percentage of the selling price. It is, of course, important that the *Government Liquor Act* of British Columbia provides, in Section 64, that the provincial government, through its agent, the Liquor Control Board, has a monopoly on liquor sales within the province. Section 95 requires that all persons possessing liquor not purchased from a Government Liquor Store, report their possessions to the Board and pay a tax,

> "at such rates as will, in the opinion of the Board, impose a tax equal to the amount of profits which would have accrued to the Government if it had been purchased from a Government Liquor Store, increasing by the addition to that amount an amount equal to ten percentum thereof."

Given the level of profits generated by a government liquor monopoly, this provision effectively imposes prohibitive tariffs on private importation of liquor from other provinces.

While British Columbia employs a quasi-tariff, other provinces such as Saskatchewan and Alberta prefer to employ quotas to restrict interprovincial trade in this product. In Saskatchewan, *The Liquor Act* provides that one may:

> "have, keep or consume as provided herein liquor that he has by any occasion brought into Saskatchewan legally purchased or otherwise acquired in any part of Canada other than Saskatchewan not exceeding one quart of spirits or one quart of wine or two quarts of beer."

Section 5(7) of *The Education and Health Tax Act* requires that residents of the Province of Saskatchewan inform the provincial government, or its agent, of tangible personal property brought into the province and to pay tax,

> "on the consumption or use of the property as would have been payable if the property had been purchased at retail in the province at the price that would have been paid in Saskatchewan."

The mere expense of complying with such laws constitutes a non-tariff barrier to trade.

A further tax pursuant to Saskatchewan's *Liquor Exporters' Taxation Act* limits trading activities. Section 3 of that Act requires persons shipping or selling liquor from Saskatchewan to points in other provinces or foreign countries to pay annually to the Crown a tax of $5,000.00.

It is arguable that a further barrier to trade results from provincial prohibitions on liquor advertising. Such prohibitions tend to protect established brands or major brands from new competition entering the market. The restrictive aspect of the advertising restriction is supplemented by packaging

regulations. The effect of packaging regulations is most dramatic in the Province of Quebec. This effect is to be seen in the Quebec regulation which requires that cider not be sold in containers "used for containing beer or any other alcoholic beverage which might cause confusion." Cider, in provinces other than Quebec, is typically packaged in the type of returnable bottles usually used for bottling beer.

In Ontario, the Liquor Control Board of Ontario officials clearly interpret their markup policy as protecting Ontario grape growers. The Board's retailing practice also limits outside competition. Wineries must meet minimum listing requirements before their products will be regularly sold at Ontario Liquor Control Board stores. An additional preference results from a provision that Ontario wineries, and only Ontario wineries, are permitted to operate a limited number of retail stores for the sale of their own Ontario wine. An Ontario wine is one "obtained from grapes, cherries or apples grown in Ontario", except when the Board's permission to add other grapes has been obtained. Such winery stores, in the year ending March 31st, 1973, accounted for approximately twelve per cent of all wine sold in Ontario. In 1976, a tax of ten and one-half per cent of the gross selling price, which Ontario wine stores were required to pay to the Board, was repealed.

3. EGG MARKETING BOARDS

In May 1970, the Quebec Federation of Producers of Consumer Eggs (FEDCO) attempted to establish a monopoly in the sale of eggs in Quebec. All eggs, whether produced in Quebec or elsewhere, were to be marketed by FEDCO. When the province of Quebec began to employ this law to reduce seriously interprovincial traffic in eggs, the province of Manitoba responded by duplicating the Quebec regulations. Manitoba then submitted these regulations to The Supreme Court of Canada in a reference case, and the Court held that the regulations were *ultra vires* because in seeking "the best advantage for provincial producers" the regulations sought to limit interprovincial trade.

The resultant warfare between the provinces in the sale of eggs, as well as similar cases in broiler chickens and other products, caused the federal government, with the agreement of the provinces, to establish farm product marketing agencies. In the case of eggs, the Canadian Egg Marketing Agency, CEMA, was established. The general purpose of the enabling legislation, the *Farm Products Marketing Agencies Act*, was said to be to "promote a strong, efficient and competitive production marketing industry". Interestingly, the Act provides that the industry is exempt from the federal *Combines Investigation Act*.

The Act further provides that marketing agencies may delegate their authority. In Ontario, the recipient of this delegation is the Ontario Egg

Producers' Marketing Board. This Board is empowered to set quotas, both in terms of the number of eggs produced and the number of fowl owned. The quotas allocated by a provincial marketing board must, under the law, total no more than the quota allocated to the province by CEMA. Quotas have been fixed in relation to specific premises.

Accordingly, the prospect exists that while combining two quotas in one farm might give substantial benefits in terms of reducing the cost of production, farmers who do so are expelled from the industry, and they lose their allowed quotas.

The rationale for this position apparently lies in the belief that marketing boards should protect the family farm from encroachment by larger, more efficient forms of production, or, as the National Farmers' Union interprets it, from ". . .the growth of integration and monopoly control" (N.F.U., 1972). As eggs are priced according to a cost of production formula, it is reasonable to expect that the price of domestic eggs will exceed that which would prevail in the absence of marketing boards.

The most dramatic effect of quotas is, of course, that potential entrants are excluded from the market, and because CEMA licenses interprovincial trade, competition from producers outside the jurisdiction of the Ontario Egg Producers' Marketing Board is limited. Because marketing boards tend to behave in a fashion which would maintain incomes, the quotas in general do have a considerable value or premium. Unfortunately, such price maintenance schemes will likely benefit the larger producers to a greater degree, and are in reality an inefficient way to aid low income producers.

The intention of provincial governments to protect local producers from competition from outside the province is evident in statements made by the British Columbia Minister of Agriculture in 1973 (Loyns, 1974). The Minister argued that egg producers should have the same power over egg sales as the Board of Liquor Control has over beverage alcohol. The control of the local board is seen in provisions such as that of the Ontario Egg Producers' Marketing Board which provide that grading stations or egg dealers who use imported eggs without first arranging the matter with the Board will not have their tenders accepted by the Board (Food Prices Review Board, 1974).

4. GOVERNMENT PURCHASING POLICIES

The growing policy by provincial governments to give a preference in government purchases to local traders may work as an effective barrier to trade. On December 8th, 1976, the Province of Quebec extended to all government departments the procedure followed by Hydro Quebec since the late 1960s. In general, the policy provides that unless the lowest bid by a Quebec firm is substantially higher than the lowest bid by non-Quebec firms, the province will buy tangible goods from the Quebec firm. In adopting this

"buy Quebec" policy, the province argues that it is only following the lead established by Ontario. The Ontario response was that the Ontario government distinguishes only between Canadians and non-Canadians, and does not discriminate against sellers in other provinces in Canada. In the Ontario case, a ten per cent price preference is given to Canadian firms.

The "buy at home" policies instituted by the province of Quebec may result in the adoption of similar policies by other provinces. The province of Manitoba, for example, has apparently entertained thoughts of establishing a similar scheme.

The potential importance of this type of policy can best be seen in reviewing the general expenditures by the provincial government of Quebec. In fiscal 1976, the province of Quebec spent approximately $200 million on general supplies, $625 million on capital works and repairs and maintenance, and a further $215 million on services. To this must be added the $1.1 billion which Hydro Quebec spent on capital projects during 1975, plus a proportion of the hundreds of millions of dollars which the province transfers annually to municipalities, hospitals and school boards.

Also, Quebec has indicated that, while it will still go outside the province for bids on goods, equipment and services, the government will also try to persuade outside suppliers to set up companies in Quebec which employ Quebeckers, and generate new production. At present, the province of Quebec estimates that only 55 per cent of Quebec Government purchases of supplies and equipment originate from within the province. Hydro Quebec, on the other hand, with a firm "buy in Quebec" policy, buys 69 per cent of its requirements from provincial suppliers. The Quebec policy that a contractor bidding for a provincial government contract have its main office in the province continues to exist, although the existence of a shell corporation permits this provision to be easily evaded. One of the results of the debate regarding Quebec's "buy at home" policy is that there is now a greater appreciation that provincial governments, and particularly the large capital-intensive utilities which they control or own outright, follow at least a subtle "buy at home" policy. The Quebec policy is an interesting attempt to define that policy, explicitly, and has created a visibility for this form of directed purchasing that was not readily apparent previously.

5. TRANSPORTATION REGULATION

The licensing by provincial governments of intra-provincial truck traffic offers potential for discrimination between provincial operators. Generally, the licensee is required to adhere to published rates, and in addition, the licensor often requires carriers to offer particular conditions of service to guarantee that small, intermediate points receive freight service. Such conditions, of course, place a burden on the industry, favour intra-provincial

trucking, and restrict the entry of potential competition. Furthermore, each province limits the weight, axle loads and dimensions of highway traffic.

The mere fact that these regulations vary from province to province may, in itself, create a barrier to trade or shipment. Clearly, a shipment between provinces must correspond to the most stringent requirements of the jurisdiction through which it passes. The provisions are not necessarily discriminatory in intent, but the cumulative effect may leave that result. There is increasing evidence that the regulations of provincial boards require trucks to return empty to a province, with the result that the long-run costs are substantially increased.

Evidence has suggested that the regulation of trucking rates by some provinces has led to higher trucking costs within those provinces (Palmer, 1973; Sloss, 1970). Feltham (1972) suggests that only the province of Quebec attempts to regulate extra-provincial trucking rates.

III. Capital

1. INTRODUCTION

This section of the survey examines legislation creating barriers to the interprovincial flow of capital. Three examples are considered: (1) provincial securities regulation of prospectus requirements, (2) business combinations and the problem of interjurisdictional statutory amalgamations, and (3) restrictions of non-resident land holdings. It is interesting to note that in each of the examples, the barriers are not large in practice. In the securities context, provincial administrative policy co-ordination has minimized the barriers. With respect to interjurisdictional statutory amalgamations, alternative methods of effecting business combinations circumvent the barriers (although at some cost). Finally, with respect to land, legislative activity has been relatively limited.

2. SECURITIES REGULATION: PROSPECTUS REQUIREMENTS

Securities regulation has been assumed primarily by the provinces and in some circumstances provincial legislation in the securities field could operate as a barrier to the raising of capital across provincial borders. A business corporation intending to raise capital in Ontario may be directly regulated by Ontario's securities legislation regardless of whether that corporation has been incorporated in Ontario, federally or in any other jurisdiction. Similarly, an Ontario corporation seeking to raise capital outside Ontario may be constrained by the respective securities legislation in the other provinces.

The governing statute in Ontario is the *Securities Act*. It requires that

any corporation raising capital through a "distribution to the public" must file both a preliminary and a final prospectus with the Ontario Securities Commission. The *Securities Act* and the regulations passed under it set out what must be included in the prospectus. By mandating certain minimum standards of disclosure, the prospectus provisions are designed to inform, attract and protect potential investors. The prospectus is filed with the Commission and the Director, if he is satisfied with it, may, as an exercise of his discretion, issue a receipt of filing. Once a receipt is obtained the company can carry out its planned financing transaction.

Although the prospectus requirements may increase the costs of raising capital by imposing the costs of preparing the necessary documents and by reducing flexibility in the timing and detailing of public securities offers, this alone cannot be construed as an interprovincial or discriminatory barrier to the flow of capital if the offer is restricted to a single province. However, if the offer is made on a nationwide basis, the offeror would, in the absence of the arrangements described below, be required to deal with and meet the prospectus requirements of each of the ten provincial authorities. Particularly if there were substantial differences in the information requirements of each of the provinces, the provincial authority in this area could impose significant costs on and thus barriers to the raising of capital across provincial borders.

However, in practice, the difficulties have been alleviated by co-operation among the provinces. The respective provincial authorities have agreed upon a standard procedure for filing a prospectus which may be followed by an underwriter or issuer wishing to clear a prospectus in more than one province. The policy operates by determining a "principal jurisdiction", generally that chosen by the issuer, and the administrator of that jurisdiction assumes responsibility on behalf of each of the other provincial administrators for clearing deficiencies with the issuer. However, the agreement clearly stipulates that there is no surrender of jurisdiction by any of the provincial authorities and the administrators retain their statutory discretion to review, accept or reject a particular prospectus. While the policy does not have the force of law and does not undermine provincial authority, it is a useful administrative agreement designed to eliminate needless repetition.

The discretionary power of the various authorities to accept or reject a prospectus has, however, caused some difficulties in raising capital in Quebec. The Quebec Securities Commission has the discretionary power to attach conditions to its granting of permission to trade in securities. Specifically, it has requested that prospectuses be filed in French in accordance with the *Official Languages Act.* This, as a result, has imposed additional costs upon an issuer wishing to trade securities in Quebec. Not only must the issuer incur the costs of translation, but, more importantly, there may be

costs associated with the added delay involved as the issuer must allow for a greater lead time in planning offers or carrying out transactions. If these additional costs are significant, a substantial barrier to the flow of capital may exist despite the otherwise effective provincial co-operation.

3. BUSINESS COMBINATIONS: INTERJURISDICTIONAL AMALGAMATIONS

There are three basic ways in which one corporation can combine with another: (1) one corporation can purchase the assets of another (sale of assets); (2) one corporation may purchase the outstanding shares of another (take-over bid); or, (3) two or more corporations may undergo a statutory amalgamation. While interprovincial sales of assets and take-over bids are regulated but not significantly hindered by provincial corporations and securities legislation, interjurisdictional statutory amalgamations are hampered in some situations and barred in others. By reducing the availability of the statutory amalgamation method, provincial legislation creates a bias in favour of the other two methods. Unfortunately, this may lead to disadvantageous tax consequences (Scace, 1976; Select Committee Merger Report, 1973) and higher transaction costs and retard some business combinations thus reducing interprovincial flows of capital and the achievement of the consequent economies.

Section 196(1) of the Ontario *Business Corporations Act* provides that any two or more corporations, including holding or subsidiary corporations, may amalgamate and continue as one corporation. The statute requires that the corporations draw up an agreement of amalgamation and have it approved by a special resolution of the shareholders of each of the amalgamating corporations. However, section 196(1) refers only to corporations incorporated in Ontario. What if a business incorporated in Alberta wished to amalgamate with an Ontario company? or a federally incorporated company? At the present time, an interjurisdictional statutory amalgamation can only be carried out by means of a two-stage process. If, for example, an Alberta company wished to amalgamate with an Ontario corporation it would first have to apply for continuation under section 198(1) of the Ontario *Business Corporations Act*. The Minister, as an exercise of his discretion, may issue a certificate of continuation. The Alberta company is henceforth treated as if it had originally been incorporated in Ontario and is therefore free to amalgamate with another Ontario corporation under section 196(1). Alternatively, the Ontario corporation could transfer out of the jurisdiction and amalgamate in Alberta.

However, the ability to transfer a company out of a jurisdiction depends upon the existence of reciprocal legislation in the receiving jurisdiction and as yet only the federal government and four of the provinces have such

legislation. Therefore, if a corporation has been incorporated in a province which does not have these "import" and "export" provisions, it cannot amalgamate with a corporation of another jurisdiction. It has been recommended that all the provinces implement provisions that would allow for interjurisdictional amalgamation without having to go through the intermediate requirement of continuation, but, as of yet, no action has been taken. Reciprocal legislation is required and that involves co-operation among all the incorporating jurisdictions. Even if there were such collaboration, there is a question as to whether or not the provinces have the competence to pass company law legislation which has extra-territorial application.

The frequent unavailability of an interjurisdictional statutory amalgamation forces resort to either the take-over bid or the sale of assets if the business combination is to be achieved. Although the availability of these alternative methods of combination means that the capital flow barriers arising from the absence of reciprocity are not insurmountable, neither are they costless. In addition to the possible adverse tax consequences in a sale of assets or the added formalities and difficulties of a take-over bid, the combining corporations may have to forego certain advantages of the statutory amalgamation procedures. For example, under an amalgamation agreement neither of the amalgamating corporations have to convey assets to the new entity nor must they enter novation agreements with respect to existing contracts; all of this occurs by operation of law.

In summary, therefore, the limited availability of interjurisdictional statutory amalgamations which arises from the provincial authority with respect to corporations leads in some circumstances to less than optimal methods of business combinations. Although the significance of this effect is minimized by the availability of the alternative methods – sale of assets and take-over bids – it would appear that the resulting barriers are of some substance.

4. LAND

A province may create barriers to the flow of capital into the province by imposing restrictions upon the holding of land. Perhaps the best example of how the regulation of transactions in land can lead to interprovincial barriers is Prince Edward Island's land policy. Section 3(3) of the *Real Property Act* states:

> "Unless he receives permission so to do from the Lieutenant Governor-in-Council, no person who is not a resident of the Province of Prince Edward Island shall take, acquire, hold or in any other manner receive, either himself, or through a trustee, corporation, or any such the like, title to any real property in the Province of Prince Edward Island the aggregate total of which exceeds ten acres, nor to

any real property in the Province the aggregate total of which has shore frontage in excess of five chains.

The grant of permission required in section 3(3) is entirely within the discretion of the Lieutenant Governor-in-Council. "Resident of the province" is defined in section 3(1)(b) of the Act as "a bona fide resident, animus et factum, of the province." The legislation was enacted in 1972 and replaced pre-Confederation legislation which qualified the land holding of aliens.

The legislation was challenged in the courts by two residents of the United States in the case of *Morgan et al.* v. *Attorney-General for Prince Edward Island et al.* The case raised considerable interest in the provincial capitals and when it was argued in the Supreme Court of Canada there were intervenors representing all the other provinces and the federal government. The Court held unanimously that the legislation was *intra vires* the provincial government as being in relation to property and civil rights in the province within section 92(13) of the *British North America Act*. It was argued in the case that the legislation interfered with the federal government's authority over aliens and naturalization under section 91(25) of the Act, but that argument was rejected by the Court. So as a result the provincial government has been able to limit the land holdings not only of aliens, but also of Canadian citizens who are non-residents of Prince Edward Island.

Saskatchewan has also recently imposed significant restrictions on non-resident land holding. *The Saskatchewan Farm Ownership Act* provides that a non-resident person may not have aggregate farm holdings in Saskatchewan in excess of the value of $15,000.00 as assessed for municipal tax purposes. The individual is defined as a non-resident person if such person does not reside in Saskatchewan for at least 183 days a year or, in the case of a farmer, does not reside within 20 miles of the border of Saskatchewan for at least 183 days a year. A non-resident creditor who has acquired land by way of settlement or satisfaction of his security interest in excess of the allowable limit has two years from the date of acquisition to reduce his holdings. The Saskatchewan Farm Ownership Board, however, has the jurisdiction to extend such two-year period. No non-agricultural corporation may have or acquire land holdings in excess of 160 acres in the aggregate without the consent of the Saskatchewan Farm Ownership Board. A non-agricultural corporation is defined as a corporation of which less than 60 per cent of all issued voting shares are owned by farmers who are resident persons, or which is not primarily engaged in the business of farming.

Any widespread exercise of this provincial authority by the provinces could lead to significant interprovincial barriers to the flow of capital devoted to land holding. To date, however, Ontario has not taken similar steps with respect to Canadian residents. However, under the *Land Transfer Tax Act, 1974*, any person who tenders for registration a conveyance of land to a non-resident of Canada is liable to a stipulated percentage tax.

IV. Labour

1. INTRODUCTION

This section of the survey examines examples drawn from legislation or policies regulating income security programmes (e.g. welfare, unemployment insurance), the self-governing professions, student access to post-secondary educational institutions, and provincial occupational licensing regimes, with a view to illustrating restrictions on the mobility of labour that exist in each of these contexts. For example, in the context of income security programmes, residence requirements are examined; in the context of the self-regulating professions, treatment of out-of-province professionals seeking entry; in the context of student access to post-secondary educational institutions, preferential treatment of local students; and in the context of provincial occupational licensing regimes, the setting of non-uniform and widely divergent entry qualifications for performing certain occupational functions.

2. INCOME SECURITY

Income security arrangements are an important factor in interprovincial mobility of labour. Provincial plans may have period residence requirements which may discourage individuals from entering the province. They may also require continued residence as a condition for receiving benefits. Limits on portability of benefits may lock individuals into the jurisdiction. Finally differences in real benefit levels between the provinces may also provide an impediment, if they are not compensated for in other ways, e.g. higher wages or private plans. Examples of the first two problems are considered below.

(a) *Welfare*

The federal government has, under the Canada Assistance Plan, stipulated statutory requirements for provincial welfare legislation. These provide a set of minimum standards in order to establish a base level of uniformity among the provinces. While the provinces have the constitutional jurisdiction over welfare matters, compliance with the federal Act is a necessary precondition in order to take advantage of the cost-sharing provisions.

A wide range of underlying conditions and personal situations can cause an individual to rely on welfare. Since most provinces desire not only to ensure a decent standard of living for all, but also to encourage recipients to become self-sufficient, inter-regional and interprovincial mobility should not be impeded. The variations in the social and economic structures of jurisdictions can make one locale more suitable to an individual's needs than another. The Canada Assistance Plan requires that no province condition eligibility on a period of residence within the province.

While none of the provinces make a *period* of residence an absolute prerequisite, many call for residence in some form. In Saskatchewan

"residence" is defined to be mere physical presence in the province; however several other provinces, including Ontario, do not provide statutory definitions. At one time British Columbia required 12 months self-supporting residence in the province, although aid would be provided to non-residents if "the exigencies of the situation warrant it". B.C.'s regulations have since been amended. As they now stand a "transient" will be granted assistance if his assets do not exceed $5. Knowledge of administrative practice is needed to assess just how restrictive many of the provinces are, particularly those which have not provided statutory definitions of residence.

The Canada Assistance Plan is not directed at regulating the intra-provincial distribution of costs between the province and its municipalities. In Ontario, the General Welfare Assistance Act imposes municipal residence requirements for short-term immediate assistance. These do not run counter to the federal Plan which only forbids provincial-residence eligibility conditions. Municipal aid for interprovincial transients is granted under a separate provision. This distinction is theoretically confined to the proper allocation of fiscal responsibility. Thus the municipalities are reimbursed by the province the full cost of aid to non-residents.

In practice, there may be discriminatory and restrictive treatment. Instances have been noted of municipal administrative procedures designed to ensure that the bulk of the funds are distributed to local indigents. For example, often only vouchers can be obtained immediately, since cash allowances are paid on a monthly basis. A local residence, in the sense of an address at a particular place, may be required as an indication of an intention to stay. Continued physical presence may also be necessary since aid will be suspended if a vacation is taken (Mossman, 1972; Mantini, 1975).

(b) *Unemployment Insurance Act*

Unemployment Insurance, while federal in scope, nevertheless restricts labour mobility, as a result of administrative policy.[1] The following examples illustrate the 'portability of benefits' problem, outlined in the introductory note. (The policies illustrated below are not directed at provincial boundaries, but are regional in scope.)

Unemployment Insurance was theoretically intended to cushion short-term frictional, involuntary unemployment. Its scope has since been extended to deal with structural and seasonal problems, providing in some ways an alternative to traditional manpower and regional development programmes and stabilization policies. In addition, administrative policy has been directing inter-regional labour flows as a result of agency interpretations of eligibility criteria.

[1] While this section is confined to several illustrations of administrative practice, it is worth noting that probably the biggest barrier to labour mobility caused by Unemployment Insurance is the fact that for some industries (e.g. fishing), in some regions, benefits are treated as a regular part of income – received every winter. Without this form of income supplementation many would be forced to move.

In order to collect benefits, an unemployed individual must be able to show that he is "available for work". A series of cases has relied on this provision in disqualifying individuals who restrict their availability to sparsely populated regions with limited employment opportunities. This doctrine was developed to the point that the mere objective fact of moving from an urban to a rural area was held to be sufficient evidence of overly restrictive demands and a lack of true desire to find employment. There are legitimate policy concerns involved in minimizing sham claims; however, current administrative practice imposes an indiscriminate barrier often at odds with the economic reality.

Several other factors should be assessed by the Umpire before coming to a balanced conclusion, including the reasons for moving (i.e. to be close to family and friends – often a source of support and job opportunities) and whether *in fact* the labour market in the new locale for the individual's particular skills is limited. In only one reported decision has the Umpire refused to disqualify a claimant because of lack of concrete economic data. He stated that evidence must be adduced as to the actual state of the specific labour market to which the claimant was restricting his search. The urban-rural distinction was insufficient.

The applied standard also produces discriminatory rights in that an individual is permitted to move from one rural area to another. It is hard to see the legal or economic rationale for a rule based solely on geography.

Another line of cases, somewhat intertwined with this issue, involves the "just cause" for voluntary termination provision in the *Unemployment Insurance Act*. The income and welfare maximizing unit in society is often the family and not the individual. Even from an efficiency standpoint, it may be economically better for both spouses to quit their jobs and relocate in response to an opportunity offered to only one of them. Nevertheless this has provided sufficient excuse to penalize the other spouse by denying eligibility for unemployment insurance. In combination with the urban-rural criterion, a disincentive to regional mobility has been imposed which appears to be contrary to the Act's intent. Application of this rule has been circumvented in several cases by relying on the marital duties of cohabitation to provide a "just cause". However, even if voluntary termination is justified, the spouse may still have to prove availability for work.

As presently applied, the above regulations and practices serve no economically valid purpose and are discriminatory in nature. Those hardest hit are singles and people from urban areas, among the more mobile and better-trained elements of the labour supply.

While it is possibly not pertinent to the above issues, the fact that the provinces do not all view unlimited mobility as desirable must be kept in mind. Economic theory suggests that factors, when not confronted with impediments to mobility, will "move" to their highest valued use. As a

result, it is quite conceivable that some areas of the country could experience severe "drainage" effects on their skilled labour supply. This would presumably make the economy more efficient but undoubtedly poses severe political and social problems.

3. PROFESSIONS

Professional associations, in exercising their licensing authority, are thought to be acting in the public interest by ensuring that minimum levels of competence are possessed by those entering into practice. For this purpose, standards should be uniform for all potential licensees. For reasons often unascertainable, perhaps due to over zealousness, lack of flexibility, or a desire to protect economic interests, admission has been grudgingly granted to out-of-province professionals.

Generally problems can arise where competence standards are set at different levels or non-technical requirements differ. Lack of uniformity impedes interprovincial mobility towards the province with the greater demands. Even where uniformity exists, lack of reciprocity, in the sense of recognition of experience and skills gained outside the province, can halt movement between provinces having substantially similar training requirements. (Safarian, 1974).

Barriers based on technical achievement, while less burdensome today, still impose costs on Canadian professionals seeking to practice in Ontario. Graduates of outside universities often must have their programmes evaluated and may be required to fill in gaps in their formal training. This can involve not only the passing of registration examinations, but also attendance at university or association courses. Efforts to remedy this have included the establishment of committees, both on a provincial and national level, to accredit Canadian and foreign universities.

Even where out-of-province university training is acknowledged, many professional bodies apply standard admissions criteria to all applicants. As a result, in several professions, experienced practitioners may be obliged to take licensing courses and examinations and redo their apprenticeships. The argument has often been made that licensing examinations should be nationally set – at least for those professional groups for whom geography does not play an important part in determining needed skills. An example is provided by the use of the federal licensing examinations by Ontario medical schools in evaluating final year students. Province-wide adoption of schemes such as this leads to uniformity both at the university and licensing levels.

In some cases, prior experience is evaluated on an individual basis and an exemption allowed; however, often an arbitrary number of years of practice is made prerequisite to seeking a license. For example, lawyers seeking to enter Ontario from other provinces must have practised law full-time for at

least three years during the five year period immediately preceding application. As with the academic criteria, non-recognition problems also exist which may restrict highly qualified personnel to teaching institutions or make them undergo unrewarding and underpaid apprenticeships.

A persistent problem has existed for many Canadians in the form of language barriers. While both English and French are national languages, little effort has been made to incorporate this fact into professional standards. Fluency in English was a standard "technical" requirement for many Ontario associations, although the trend appears to be now leading towards acceptance of French as an alternative. In Quebec, as is well known, all professionals must now pass French proficiency tests. Those who fail may be granted one year licenses, during which period the test must be successfully completed.

Non-technical requirements arouse much greater suspicion with respect to their motivating factors and only seem to indicate a desire to restrict entry into the professions. Age and citizenship are common restrictions, though they are less relevant to interprovincial mobility. Provincial residence may be desirable to ensure a greater degree of accountability; however, period-residence requirements cannot be justified as being in the public interest. It is difficult to see how the public interest was served by a former regulation which required entering pharmacists to reside for six months in Ontario prior to the date of application. Similarly, differential registration fees can only be discriminatory in character.[2] In one case, pharmacy, an association went so far as to have explicit quotas on out-of-province entrants; however, this has since been revoked.

Temporary and conditional licenses are occasionally available for those failing to fulfill all the requirements. While the regulations usually stipulate the minimum restrictions on the scope of the permitted activities, discretionary powers generally exist with respect to granting registration and imposing additional terms on the licensees.

The general tendency in current revisions of regulations is to discontinue explicit conditions limiting non-resident licensing and replace them with grants of discretionary evaluation powers to the responsible licensing agents of the associations. Even where conditions are laid out in the regulations, discretion to exempt is provided for. It is therefore difficult to come to any conclusion as to how restrictive in fact most associations are without a more detailed examination. For example, the legislation governing physicians and pharmacists was changed in response to the Ontario government's Committee on the Healing Arts. Whether the practices complained of are still being continued cannot be ascertained by mere perusal of the regulations.

Despite the nature of the above restrictions, in practice it is not too

[2]There may be an argument that the increase in fees goes toward defraying the cost of evaluating prospective licensees; however, the magnitude of the differential in some cases cannot be explained solely by this factor.

difficult for most Canadian professionals to move between provinces. Citizenship requirements aside, greater difficulties exist for immigrants, since international accreditation does not often extend beyond the Commonwealth and the U.S. Reciprocity arrangements in one province may not be recognized by another. Therefore, not only do newcomers often immigrate to a specific province, but their subsequent mobility is much more highly limited than that of other Canadians.

4. STUDENTS

While the free flow of factors may be necessary to achieve a national optimum, increased mobility does not necessarily benefit all provinces equally. It is quite possible that "brain drains" would arise in some areas, providing serious losses in capital and impediments to regional growth. (Even if mobility existed, in order to realize the potential gains there must exist adequate social capital and training facilities.) (Safarian, 1974).

Several university programmes reflect the above concerns in their admissions policies. In Ontario, quotas seem to be confined to specific faculties and there are no general university-wide standards. For example, all medical schools in the province weigh applicants' performance records by a geographic factor, often with priority going even to the local regions and not just the province. (See Appendix.) Yet Ontario law schools do not have any acknowledged preference system.

The basic economic trade-off lies between the gains from improving the quality of schools by obtaining a better student body and the losses from training people who may go elsewhere to work. Several other factors may influence the decision process. Where the number of spaces available is limited in relation to desired output or where the number of acceptable, qualified provincial applicants is too small a proportion of those seeking to enter, protectionism may motivate a quota system. It is also possible that differences in programmes provide a non-economic incentive. For example, if a university was unique in offering a pre-law or pre-medicine undergraduate programme, it is only fair to guarantee its successful graduates a place in its first year professional programme.

Unacknowledged restrictions may exist in terms of subjective evaluations of the quality of other universities' programmes. There may also be an over-inflated view of a university's own student body.

Most out-of-province students must incur a penalty in attending university in Ontario. Even if residence status has been obtained, the Ontario Student Assistance Plan will not provide aid unless a 12 month residency requirement is fulfilled other than in a post-secondary institution prior to the date of application.

If a student decides to attend a university outside his province of resi-

dence, he is only eligible for a loan and not a grant. A student must be careful as to how he spends his time outside the province. For example, a Quebec student loses his residency status when he has been outside the province for 12 consecutive months and not enrolled in full-time studies. It is conceivable that he or she may have worked 9 months in Ontario and 3 months in Saskatchewan. As a result no province's residence requirements are fulfilled.[3] Difficulties encountered generally arise because the largely federally financed loan plan is administered separately by each province in conjunction with provincial grant programmes and cannot be directly applied for alone.

5. PROVINCIAL OCCUPATIONAL LICENSING

In addition to the more publicized forms of licensing professional services, many provinces, and the municipalities within those provinces, require those employed in various trades or occupations to obtain a license prior to pursuing their employment. A study carried out for the Economic Council of Canada calculated that some 31 per cent of craftsmen in production process occupations and 25 per cent of sales occupations were subject to some form of licensure (Dodge, 1972). The Province of Ontario licenses some thirty-three occupations while municipal governments in the province license some fifty-two trades and businesses pursuant to *The Municipal Act* and ten other trades and businesses subject to specific statutes.

A report prepared by the Advisory Committee of Municipal Clerks in Ontario recommends that the power of municipalities to license various forms of trades and occupations be extended to the licensing of business, where business is defined as "the carrying on of a commercial or industrial undertaking of any kind or nature, or the providing of professional, personal or other services for the purpose of gain and profit" (Advisory Committee, 1976). The Report makes it clear that municipalities regard this licensing function as regulatory, not revenue generating, in effect, and the stated purpose of such licensing is that "municipal licensing should prevent circumstances arising in which public security is liable to be jeopardized, public morality disturbed, or public hygiene affected".

While, of course, most of these occupational licensing requirements apply equally to people within or outside Ontario seeking to enter an occupation in Ontario, the pervasiveness of widely different entry standards from jurisdiction to jurisdiction for identical occupational functions creates impediments to the free flow of skilled personnel among these jurisdictions.

[3]The Ontario Ministry of Colleges and Universities informed us that in such a case an arrangement most likely could be worked out with the university's Student Awards Office to apply for an Ontario Student Assistance Plan loan.

V. Uniformity of Legislation

The Canadian Conference of Commissioners on Uniformity of Legislation, which has met annually since 1918 (Proceedings, 1972-74) is charged with promoting uniform provincial legislation in areas of provincial jurisdiction in Canada. The issue of legislative uniformity has long been a vexed one in Canada, as it is in any federal system. Obviously, as enterprises and markets have become increasingly national (and international) in scale and scope, legislative requirements pertaining to the same subject matter which vary from province to province increase the cost of doing business, and thus costs to consumers, as firms face multiple compliance requirements (e.g.; in a consumer law context, in preparing different advertisements, mail order catalogues, standard form contracts and in training personnel to meet differing standards; in an environmental law context, in designing different pollution control programmes to meet differing standards; and in both contexts, compliance with differing statutory information and reporting standards). These costs are often exacerbated by virtue of overlapping jurisdictions on the part of the Federal Parliament and the provinces, which generate further legislative divergences.

Non-uniformity of legislation also probably imposes direct costs on consumers and other interest groups in the impediments it creates to promoting clearer understanding of legal rights and obligations. Other costs are generated by duplicative and wasteful investment of resources in the development and enactment of similar legislation. Related costs are generated by overlapping enforcement activities. All of these costs impede mobility of resources across jurisdictions.

On the other hand, against these costs it is argued that too rigid an adherence to an objective of uniformity constrains policy initiatives, innovation and experimentation, and creates tendencies to settle for the lowest common denominator, in policy terms, as the price of uniformity. Also regional differences of circumstance or aspiration may be suppressed.

In any event, the fact of the matter is that Canada has an extremely weak record of commitment to uniformity of legislation relative to other federal states, such as the United States and Australia. Moreover, many of the legislative divergencies in given fields in Canada do not reflect broad policy differences but instead largely technical differences or differences of detail. The Uniformity Commissioners are woefully under-resourced and have an almost invisible public profile relative, for example, to the U.S. Uniform Law Commissioners, who have been impressively successful in promoting major pieces of uniform legislation, such as the Uniform Commercial Code, which has been adopted by all states but one in the United States.

In contrast, in Canada, legislation, for example, governing consumer credit transactions (e.g. truth-in-lending, creditors' remedies) varies markedly

from province to province, with the situation being further complicated by the recent introduction by the Federal government of the *Borrowers and Depositors Protection Act* which, if enacted, will cover much of the territory already covered by provincial legislation. A similar situation exists in relation to legislation regulating misleading advertising and other unfair trade practices (Trebilcock, 1976), consumer product and housing warranties, and environmental protection (CCH, *Sales and Credit Law Guide;* Eco/Log Information Services).

Appendix

ONTARIO MEDICAL SCHOOL ADMISSIONS –
GEOGRAPHIC CRITERIA AND EXPERIENCE.

McMaster University: Some weighting according to bona-fide place of residence will be used in the following priority:

a. Hamilton Health Region and Northwestern Ontario (defined as west of Wawa to the Manitoba boundary).
b. The rest of Ontario.
c. The rest of Canada.
d. Other countries.

To qualify for (a) or (b) above, an applicant must have resided for at least three years in the area since the age of 14 or attended a university in the area for at least 3 years.

Estimates on 1974-75 First-Year class

Number of	In-Province	Out-of-Province	Foreign	Total
Applicants	1,241	364	391	1996
Entrants	72	6	2	80

Queen's University: Place of residence and location of the university where studies have been undertaken are not criteria in the selection process; however, when two or more applicants are considered equal in all other respects, preference will be given to a candidate who has studied at Queen's University.

University of Ottawa: All things being equal, preference will be given to bona-fide residents of Ottawa and its regions and to those of the Province of Ontario.

Estimates on 1974-75 First-Year class

Number of	In-Province	Out-of-Province	Foreign	Total
Applicants	1,300	500	—	1800
Entrants	75	9	—	84

University of Toronto: No more than 25 places will be offered to highly qualified non-Ontario residents (Ontario residents have resided in Ontario for at least one year immediately prior to proposed date of enrolment).

Estimates on 1974-75 First-Year class

Number of	In-Province	Out-of-Province	Foreign	Total
Applicants	1,450	610	225	2285
Entrants	216	14	10	240

University of Western Ontario: Priority is given to residents of Southwestern Ontario and those areas not serviced by an Ontario Medical School. Only in special circumstances are out-of-province residents admitted.

Estimates on 1974-75 First-Year class

Number of	In-Province	Out-of-Province	Foreign	Total
Applicants	1300	197	3	1500
Entrants	96	1	1	100

All applicants for the above universities must be Canadian citizens or landed immigrants. Foreign students must be sponsored by Government of Canada agencies.

Sources: A. Geographic Weighting

Council of Ontario Universities, Ontario Medical School Application Service, *OMSAS Instruction Booklet for 1977 Entering Class.*

B. Estimates on 1974-75 First-Year Classes

Association of American Medical Colleges, *Medical School Admissions Requirements 1975-76 U.S.A. and Canada.*

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The Province and Stabilization Policy

Thomas A. Wilson

This paper considers the potential role for fiscal policy by Ontario in stabilizing economic activity. On the basis of such statistical evidence as is available, the author concludes that fiscal actions by Ontario can have a significant effect on the Ontario economy at least in the short run. Because of possible effects on the economies of other regions, discretionary fiscal policy by Ontario should be planned in consultation with the federal government and other provinces. In order to improve the automatic stability of the overall fiscal system, changes in Federal-Provincial revenue stabilization arrangements are recommended.

The conventional wisdom is that, in a federal state, primary responsibility for stabilization policy must rest with the central government (*Report of the Royal Commission on Taxation* 1966, vol. 2, 91-102). Indeed much of the literature on the provincial/municipal role in stabilization policy has focused on the question whether the fiscal behaviour of these governments may be perverse from a countercyclical standpoint (Rafuse 1965, 63-201). Surprisingly little attention has been given to the question of whether a unit within a federation can make a substantial contribution to discretionary stabilization policy.[1]

In stating the case against a major *independent* role for the provinces, the

[1] For an exception, see Barber (n.d.)

Royal Commission on Taxation (the Carter Commission) stressed the following arguments:

(1) Provincial economies are so open that a large part of any fiscal stimulus or restraint is exported to other provinces.
(2) Lack of coordination among the provinces could lead to offsetting or ill-timed changes.
(3) Lack of control over the money supply and traditional capital market debt limitations could "create barriers to sharp increases in provincial and municipal deficits" (*Report of the Royal Commission on Taxation* 1966, vol. 2, 102).

However, the Carter Commission did recognize that the provinces could contribute to stabilization policies, but recommended that they do so within a general cooperative framework in consultation with the federal government. In this connection, the Commission made important recommendations for the following:

(1) Improving federal/provincial cooperation in framing fiscal policy
(2) Designing federal/provincial revenue arrangements to ensure that provincial/municipal behaviour is not destabilizing.

In view of continued growth of the Provincial/Municipal Sector – recognized in the Carter Commission Report, but of increasing importance in recent years – the case for a greater role for the provinces in stabilization policy has strengthened.[2]

While the federal government now has, and will continue to have, sufficient fiscal and monetary instruments to pursue an adequate stabilization policy from a national standpoint, the involvement of the provinces in stabilization policy could:

(a) permit better performance in terms of other policy objectives,
(b) more important, enable appropriately offsetting or reinforcing regional stabilization policies to be pursued in relation to regional objectives.

The first point follows from the most elementary view of resource allocation. The stabilization problem can arise from savings-investment imbalances in the private domestic sector, economic fluctuations abroad transmitted to our economy via trade and capital flows, and imbalances in the government sector itself – the classic case being war and war-related spending. When excess demand is generated by one or other of these factors, stabilization can be achieved by reducing public or private demands via expenditure restraint or tax increases. Which route to follow and which particular categories of spending to restrain or taxes to increase should be determined on efficiency as well as stabilization grounds. Leaving aside for the moment timing and multiplier effects – which are crucial from a stabilization standpoint – the

[2]Excluding Intergovernmental Transfers, Provincial, Municipal and Hospital Expenditures were 22.6 per cent of GNP in 1974, when federal expenditures were 16.1 per cent of GNP.

choice of expenditure to cut or tax to increase should be based on the usual criteria for efficient resource allocation based on evaluation of marginal social costs and benefits. If the set of fiscal instruments to be evaluated by these criteria is arbitrarily limited by the constitutional assignment of spending and taxing responsibilities in a federal state, a less efficient stabilization policy will result. Hence – provided that the timing of appropriate actions is not affected – the involvement of the provinces in stabilization policy should permit a more effective use of fiscal policies from the standpoint of efficient resource allocation.

More important than the improvement in efficiency resulting from the involvement of the provinces in stabilization policy is the improved potential for the achievement of regional and economic objectives. Canada has faced for some time a chronic problem of regional imbalance, coupled with greater cyclical patterns in some regions. In many cases, expansionary fiscal policies could be most effective in countering recession if they could be focused on the more depressed regions; at other times, restrictive policies would be more effective in resisting inflation – at lower cost in terms of unemployment – if they could be aimed at the expanding regions. However, political tolerance of federal moves to accommodate regional disparities in federal stabilization policies appears extremely limited, particularly in the case of restrictive policies.[3] Hence the use of provincial policies as an adjunct to federal policy – reinforcing federal policy in those regions where the cyclical problem is most acute, and offsetting federal policy where the cyclical problem is less than (or indeed opposite to) that of the nation – could improve the overall performance of stabilization policy.

Basic Issues in Economic Theory

The preceding discussion has presumed that the provinces could pursue their own fiscal policies and that these could have an economic impact. In view of the negative views expressed by the Royal Commission on Taxation, and growing skepticism of fiscal policy generally among certain economists, it is appropriate to examine the basic issues of whether fiscal policy by a province is feasible and effective in terms of its impact on economic activity within the province and the nation.

The conditions under which a provincial fiscal policy can have a national economic impact are precisely the same conditions where a debt-financed federal fiscal policy is effective and where swings in private investment demand would generate swings in the general level of economic activity unless offset by policy changes. Under those conditions where the impact of

[3]The ascerbic reaction of Ontario and other "have" provinces to the federal government attempt to reduce investment in designated areas in 1969-70 is a case in point. See Ontario Budget for 1971.

debt-financed federal fiscal policy is zero (the pure monetarist case), the *national* impact of provincial fiscal policy is also zero. However, fiscal policies within a province may nevertheless be effective in influencing economic activity *within* the province – but in the pure monetarist case, this must be at the expense of economic activity in other provinces. In a pure monetarist world – where only monetary policy matters from a national standpoint – provincial fiscal policies that affect the regional distribution of economic activity paradoxically could become important adjuncts to national monetary policies.

The available empirical evidence[4] indicates that both monetary and fiscal policy have an important impact on the Canadian economy under a floating exchange rate system in the short run. Under a fixed exchange rate system, the two policies are no longer independent, since a given fiscal change calls forth the appropriate monetary changes required to maintain Balance of Payments equilibrium. Hence from the standpoint of a central government, the statement that fiscal policy is more effective under a fixed rate than under a floating rate is not particularly meaningful, since the same combination of monetary and fiscal policy as occurs under the fixed rate would bring forth precisely the same results under the floating rate.

From a provincial standpoint, however, the difference between the exchange rate regimes is perhaps more meaningful, precisely because the province does *not* control the money supply and hence cannot engineer particular monetary/fiscal combinations under a floating exchange rate regime. Under a fixed rate regime, on the other hand, provincial fiscal policies call forth appropriate companion monetary policies designed to counter Balance of Payments effects in precisely the same way as do equivalent federal policies. Paradoxically, therefore, a fixed exchange rate regime gives the province an indirect influence on the money supply.

Because of induced monetary effects, a given fiscal change may therefore have a larger impact under a fixed exchange rate system than under freely floating rates, with "managed" floating rates presumably somewhere in between. Hence the *national* impact of a federal or a provincial fiscal change may be weaker under a floating exchange rate than under a fixed exchange rate.[5]

In the case of fiscal policy by a single province, the offsetting effect due to an induced exchange rate change is spread over the country as a whole – hence the "external" negative effects of the policy on other provinces could be magnified (or an otherwise positive external effect offset).

[4] Multiplier analyses with various econometric models of the Canadian economy are generally consistent with the view that fiscal policy may be used for short run stabilization purposes. See Carr *et al.* (1976); Jump and Wilson (1975); Helliwell (1974, 241-278). See also the forthcoming papers from the Canadian Macro Models Comparison Project.

[5] The conventional wisdom for the Canadian economy is that a given fiscal change has a larger impact under fixed than under floating exchange rates. However simulation with one version of the TRACE model yields opposite results (Carr *et al.*, 1976).

Magnitude of Provincial Multipliers

The lack of control of the money supply – related to the issues considered above – was only one of the reasons outlined by the Royal Commission on Taxation in arguing against independent provincial fiscal policies. Leakages in the highly open regional economies was another. Where import leakages to other regions are very large, the principal impact of fiscal policy within a region is on other regions, with potentially destabilizing perverse effects. This is clearly a valid argument for the question whether stabilization policies should be pursued by small units – probably all municipalities and most likely the smaller provinces. For the larger units in the Canadian Confederation – definitely Ontario, Quebec and British Columbia, and perhaps the three Prairie Provinces – the leakages are probably not sufficiently large to render an appropriate provincial fiscal policy totally futile, as would be the case for smaller units.

Unfortunately, the available data do not permit precise estimation of inter-provincial leakages. Despite the expenditure of vast sums by the federal government on regional equilization policies, and the active pursuit of provincial stabilization policies by some of the major provinces, the provincial/regional data base in this country remains grossly inadequate. Data on inter-provincial/inter-regional trade flows are fragmentary; and data on inter-provincial capital flows non-existent.[6] The inadequacies of basic regional data account for the fact that, although several econometric models of the Ontario economy now exist, none can be used to calculate accurate and complete estimates of the impact of changes on the Provincial economy.

In the absence of adequate data, we necessarily fall back on what is available. A study by Statistics Canada for 1967 on inter-provincial shipments of manufactured products (Statistics Canada, 1971) gives us some idea of the strength of inter-provincial linkages in each province.

The data in this study indicate that inter-provincial leakages out of Ontario demand for manufactured products are quite modest – 82 per cent of production destined for Ontario destinations was produced within the province. The second largest province, Quebec revealed the second smallest inter-provincial leakage – 66 per cent of production destined for Quebec was produced within the province. In British Columbia, the comparable figure was 55 per cent, and in Prince Edward Island and Newfoundland, about 20 per cent. In other provinces the figures lie between 33 and 45 per cent.

These leakages are not so large as to render an independent fiscal policy pursued in the three largest provinces quixotic. However, they do indicate that important spillovers into other provinces will occur.

However, in the case of Ontario, the indirect repercussions of increased

[6]For an attempt to design a regional model in the face of these inadequacies, see Lynn (1976).

activity in the rest of the country on the demand for Ontario manufactured products is significant, since 31 per cent of manufactured products destined for the rest of the country originated within Ontario. The comparable figure for Quebec was only 14 per cent.

Since the leakages from the Prairie Provinces and from the Atlantic Provinces are somewhat larger, interprovincial leakages for the individual provinces in each of these regions could create more serious difficulties for the use of certain fiscal policies – such as general tax changes – for stabilization purposes within these provinces.

The manufacturing sector is, of course, not the whole economy. In trade, services, and construction, interprovincial linkages are doubtlessly weaker; in agriculture and mining they could well be stronger. However, the manufacturing figures are nevertheless useful for illustrative purposes.

Other sources of difference in provincial responses to fiscal policy involve differences in the behavioural responses of spending to income, different propensities to import from abroad, and differences in effective marginal tax rates. A study of consumption functions in different regions found that the marginal propensity to consume in Ontario is somewhat smaller than in the rest of the country (perhaps reflecting Ontario's higher average income level) (Gillen and Guccine, 1970). The ONFORM model import equations imply that the marginal propensity to import from the rest of the world is somewhat higher in Ontario than in the rest of the country, but that this difference is declining over time (Jutlah, 1972, 28). As for marginal tax rates, the higher income level in Ontario tends to increase the tax leakages, but the fact that Ontario has the second lowest level of provincial income tax rates in the country offsets this effect.

On balance these differences would suggest that the national multiplier for Ontario fiscal instruments is probably somewhat smaller than the multiplier for corresponding federal fiscal instruments. Because of the important leakages due to inter-provincial trade flows, the *provincial* multipliers for Ontario fiscal instruments will be smaller than the corresponding national multipliers, i.e. part of the effect of Ontario's actions would be felt in other provinces.

The appendix briefly considers the possible use of the various econometric models of the Ontario economy. Based on these models and on an available national model, only very crude maximum and minimum estimates of the first year multiplier effects within the province of provincial government spending and tax policy changes can be made.

Without knowledge of precise numerical magnitudes, we can nevertheless reach some tentative conclusions:

(1) While Ontario provincial fiscal multipliers are smaller than the national federal fiscal multipliers, the Ontario multipliers are not trivial.

(2) The short-run multiplier for provincial government spending is no doubt stronger than the multiplier for tax cuts. Because of lower import leakages for government spending relative to provincial tax cuts, this difference is probably greater than the corresponding difference at the national level.
(3) While the bulk of a change induced by Ontario fiscal policies would occur within the province, significant economic effects would be generated in other provinces (with greatest impact in Quebec).
(4) Probably the magnitude of all fiscal multipliers would be reduced under a flexible exchange rate system.[7] Under flexible exchange rates impacts on other provinces attributable to induced exchange rate changes would also become a possibility.

The Political Arithmetic of Stabilization Policy in Large Provinces

In recent years virtually all of the larger provinces have adopted explicit counter-cyclical fiscal policies, with Ontario and Quebec leading the way.[8] While the analysis of the previous section suggests that such efforts are not completely in vain, there are political as well as economic reasons for the provinces assuming the "burden" of partial responsibility for stabilization policy.

It would be very difficult for any provincial government, but particularly for the governments of large provinces such as Ontario, Quebec and British Columbia, to admit that they are powerless to deal with the prevailing socio-economic problems of unemployment and inflation. Even if their own policies were in fact futile, such governments would nevertheless feel that they must be *seen* to be doing something about these problems. Given that provincial treasurers are very careful to finger the federal government for final responsibility for stabilization policy, the political risks involved in taking some action are surely outweighed by the political risks involved in doing nothing. When recovery comes – as it always does – some credit for the policies adopted can be claimed.

With the political arithmetic favouring some action, it is perhaps more important to design a framework for a provincial role in stabilization policy than to argue against such a role. In any case, the multiplier analysis does suggest that provincial actions do have real economic effects. How to channel these actions to constructive purposes is perhaps the most important task.

[7]See footnote 5 above.
[8]For an analysis of provincial fiscal policies in 1975, see Wilson and Jump (1975).

Possible Perversity of Provincial/Municipal Fiscal Policy

The perversity hypothesis that provincial/municipal fiscal actions are destabilizing owes much to its American origins.[9] Given the small size and limited financial strength of most states, the view that the fiscal behaviour of state and local units could be characterized as naive budget balancing behaviour has long worried U.S. fiscal experts. Naive budget balancing behaviour – i.e., always balancing the budget regardless of economic conditions – implies pro-cyclical and hence destabilizing behaviour by any state or local unit dependent upon income-sensitive revenue sources, such as personal income, sales or corporate income taxes. This hypothesis has been tested empirically in the U.S. with mixed results (Rafuse, 1965, 177). For Canada, the available econometric evidence suggests rejection of the perversity hypothesis for the provincial/municipal sector as a whole (Robinson and Courchene, 1969). However, further testing is clearly in order since the provinces (and indirectly, the municipalities) are becoming more and more dependent on cyclically sensitive revenue sources. Dealing with this potential problem requires appropriate federal/provincial revenue stabilization arrangements, and, if feasible, appropriate provincial/municipal stabilization arrangements.

A little noticed recommendation of the Royal Commission on Taxation should be re-considered (or perhaps seriously considered for the first time!) This was their proposal for federal stabilization of provincial tax yields from income sensitive taxes at their estimated yields at the full employment level of gross national product *(Report of the Royal Commission on Taxation*, 1966, vol. 2, 109). Applied to those tax fields currently shared by the two levels of government (personal income taxes and corporate income taxes) this measure would largely eliminate any possibility of perverse fiscal behaviour by provincial governments.

Although *automatic* perverse behaviour (in contrast to inappropriate discretionary policies) is unlikely to occur in a large province, the smaller provinces could behave perversely, particularly in the event of a major recession such as the one recently experienced by the United States (where state and local governments apparently responded dramatically to the slowed growth of their revenues). Hence such measures warrant the full support of the Province of Ontario in federal/provincial fiscal policy negotiations.

Within its own house, the province needs to ensure revenue stability to the municipalities, in order to prevent possible perverse behaviour at the local level. The logical way to do this is to carry out fiscal planning on a full employment basis, and base revenue transfers to municipalities on estimated full employment provincial revenues.

[9]For a thorough survey, see Rafuse (1965).

Selection of Instruments and Objectives

What should the objective of Ontario stabilization policy be? What instruments should be used? Because of Ontario's large size and central location, to some extent national objectives need to be taken directly into account in framing fiscal policy at the provincial level. For example, if the federal government is precluded by political pressures, international arrangements, or constitutional difficulties from pursuing a sufficiently vigorous expansionary or contractionary fiscal policy, Ontario may provide a useful supportive policy by following the federal lead. Given Ontario's role in the Canadian economy, this may indeed be a typical case. In such circumstances the Ontario stabilization authority should look at the same objectives as the federal authority: unemployment, inflation, and economic growth of the nation, and take into account the federal actions already undertaken or in prospect in framing its own policies. In these circumstances, close consultation with the federal government is particularly important.

In other less frequent circumstances, the objectives to be considered by the Ontario government may diverge from the objectives of the federal government. This would occur when the impact of federal policies was unusually strong in the province, or when economic developments in Ontario diverged significantly from developments in the rest of the country. In either of these circumstances, the Ontario stabilization authority should become more concerned with the regional indicators of Ontario's performance – and how to deal with divergencies between the Ontario economy and the rest of the country. For example, if under boom conditions demand pressures are extraordinarily strong in Ontario, additional restrictive fiscal measures within the province would be appropriate. On the other hand, if a federal anti-inflation policy is having particularly serious employment effects in Ontario, an offsetting expansionary policy within the province could be in order.

The instruments to be selected depend in part on which role Ontario is playing. If the Ontario policies are designed simply to reinforce federal policies, positive leakages are not of concern, since the external effects on other provinces are presumably beneficial. On the other hand, if the province is pursuing a differential policy because of divergences between Ontario economic patterns and patterns in the rest of the economy, the ideal policy would minimize external effects.

The largest leakages and hence the largest external effects would be associated with general changes in taxes paid by individuals (such as the general sales tax and personal income tax). Expenditure programs tailored for maximum impact within the province would have the lowest leakage and lowest external effects. Taxes on business would have more unpredictable effects. As many observers have noted in considering national stabilization policies, the timing and magnitude of investment responses to changes in

corporate taxes or credits is considerably more uncertain than the timing or magnitude of the response of consumer spending to changes in personal income taxes or sales taxes. Furthermore, and most important, changes in business taxes have unpredictable external effects which could exacerbate relations between provinces. For example, reductions in corporate taxes could induce new firms to locate in Ontario instead of other provinces. While temporary general corporate tax reductions would probably have little impact here, temporary investment tax credits and temporary acceleration of corporate capital cost allowances could have more important immediate locational effects. Their use for pure stabilization policy purposes should therefore be avoided, except in unusual circumstances where the external effects are desirable from the standpoint of other provinces.

Forecasting, Lags and the Effectiveness of Discretionary Fiscal Policy

Fine-tuning has few proponents these days. The problems of fine-tuning are magnified at the provincial level because of data problems and because of the need to consult with the federal government and with other provinces. Adequate quarterly data on a consistent provincial accounting basis similar to the National Accounts do not exist. Reliance upon the fragmentary current data on the state of the provincial economy could easily lead to erroneous conclusions about the economic outlook. Until such time as an adequate quarterly provincial data base is developed, the province should design its fiscal policies first to avoid perverse discretionary changes, and second to follow the lead of federal policy changes. Only where the evidence is clear that the economic performance of the province is diverging from that of the nation should offsetting discretionary policies be initiated.

To reduce the possibility of perverse discretionary fiscal changes, the province should develop revenue and expenditure estimates on a full employment basis,[10] and carry out its fiscal planning within such a framework. Presenting full employment budget projections as well as actual budget projections would enable observers to separate the effects of automatic fiscal changes induced by changes in economic activity from discretionary changes implemented by policy makers.

In deciding whether to follow the federal lead in adopting expansionary or contractionary discretionary fiscal changes, Ontario should take into account the magnitude of the gap between actual and desired economic performance and the probable effect of the federal policies. The political advantages of adopting supplementary expansionary policies designed to

[10] The government of Ontario presented full employment budget estimates in its budgets of 1973 and 1975.

combat recession are fairly obvious. It often takes greater political courage to adopt contractionary fiscal policies to deal with inflation, but the apparent success of the current expenditure restraint program at the provincial level is promising in this connection.

Recent history provides two illustrations of the appropriate use of fiscal policies in Ontario to supplement federal fiscal policies.

In its budget of 1975, Ontario introduced several major changes designed to blunt the impact of the 1974-75 recession on the Ontario economy. These included a temporary home-ownership grant program, a temporary general sales tax reduction, and a temporary suspension of sales taxes on automobiles. These measures were intended to generate maximum effects during 1975, and to aid the flagging construction and automobile sectors.[11] The general economic effect of the program was significant and of the appropriate direction given that, unlike previous recessions, the recession of 1974-75 was particularly severe within the province. However, the temporary suspension of the sales tax on automobiles was not well-designed, because import leakages from automobile sales are extremely large. Hence a good portion of the economic activity generated by this temporary sales tax suspension no doubt accrued abroad.

In 1976-77 the Ontario government has pursued a policy of expenditure restraint, while allowing tax rates to return to their pre-1975 budget levels.[12] This policy reflects the increased weight placed on the objective of fighting inflation. If greater weight is to be attached to reducing inflation than to reducing unemployment, the current expenditure restraint policy is appropriate, and indeed appears more stringent than its federal counterpart.

The recent record therefore suggests that discretionary fiscal policy by the province of Ontario has generally played a constructive role. No doubt further improvement may be attained if better information on the Ontario economy is made available and better estimates of the effectiveness of alternative provincial policies obtained.

Recommendations

1. Ontario should present revenue and expenditure estimates on a full employment basis. This will permit a separation of automatic from discretionary fiscal changes and help reduce public and political pressures for perverse fiscal policies.

[11] For a discussion of these measures, see the 1975 Ontario Budget. For an analysis of the economic effects of these measures, see Wilson and Jump (1975).

[12] For a discussion of the expenditure restraint program, see the 1976 Ontario Budget.

2. Ontario should support the implementation of a comprehensive federal-provincial revenue stabilization scheme designed to insulate all provinces from major cyclical swings in their revenues.
3. Ontario should implement a similar policy in its arrangements with the municipalities. It is important to insulate the municipalities – which have much more limited sources of funds and borrowing than the province – from cyclical changes in these revenues.
4. Discretionary fiscal policy by the Province of Ontario should be planned with caution and with maximum consultation with the federal government and other major provinces.
5. When it is appropriate for the Province of Ontario to play an adjunct role in supplementing federal policies which are of themselves insufficient, across-the-board personal income tax reductions have much to recommend them. (An example of this policy was the matching of the federal temporary tax reduction with a corresponding relative Ontario tax reduction two years ago.) In this instance, where temporary general stimulation or restriction is in order, one need not be much concerned about the external effects of the provincial fiscal stimulus.

   General sales taxes changes can also be effective, as the experiment with the temporary sales tax last year demonstrated, but their too frequent use could lead to destabilizating speculation.
6. When economic conditions within the province diverge significantly from those within the nation as a whole, provincial fiscal policy should be carefully tailored to minimize external effects on other provinces. The acceleration or deceleration of selected government expenditure programs – such as road construction and improvements – could well be the most useful instrument in such cases.
7. Both politically and economically, it would be foolish for Ontario to assume major responsibility for stabilization policy – which belongs with the federal government under any conceivable division of powers within Confederation. Ontario fiscal policies can play a useful secondary supporting role but only that.

Appendix: Notes on Ontario Models

The existing econometric models of the Ontario economy are, unfortunately, not well designed from the standpoint of analysing the provincial impact of provincial fiscal policies. Two models have been developed within the Ministry of Treasury, Economics and Intergovernmental Affairs (TEIGA). The first prototype model is described in a paper by D. Haronitis (1971) but has not been maintained. The "ONFORM" model reported on by

C. B. Jutlah (1973, 1972) is maintained and used in connection with the TRACE macro-model of the Canadian economy for medium- and long-term projections. Neither of these models yields accurate estimates of the provincial multiplier from government spending or tax cuts, since inter-provincial trade flows are not taken into account. As a result, the multipliers of Ontario fiscal instruments are overstated for Ontario and understated for the rest of the country.

An Ontario provincial sector has recently been added to the TRACE national model, but it is completely recursive to the national model.[13] Hence, this augmented version of the TRACE model, while useful for analysis of trends and of the impact of alternative national policies on Ontario, cannot be used to estimate the complete economic impact of provincial fiscal policies within the province.

A quarterly model of Ontario has been developed by W. F. Empey of Data Resources of Canada.[14] This model is recursive to the Institute for Policy Analysis Quarterly Forecasting Model of the national economy,[15] but does include allowance for the impact of two general fiscal policy instruments within the province – direct taxes and government employment.

Since the Empey model is recursive to the Quarterly Forecasting Model, an analysis of the multipliers for provincial policies would require a two-stage analysis: (a) solution of the Quarterly Forecasting Model with the national impact of the provincial changes included, and (b) conditional on (a), solution of the Empey model with the provincial changes included. Hence, in contrast to the ONFORM model multipliers, which probably overstate the provincial multipliers, an analysis using the Quarterly Forecasting Model and Empey's model would probably understate these multipliers.

The basic problems in all of these models are related to data inadequacies. Aside from a Statistics Canada survey of 1967 and other fragmentary information, no consistent series on interprovincial trade flows exist. Since the major objective of each of the model builders was to develop models useful in forecasting and trend analysis, they naturally had to avoid specification of equations which depended on such data.

Two recommendations follow from this disappointing survey:

(1) A policy-analytic model should be constructed which utilizes available cross-section data in order to provide estimates of relevant equilibrium multipliers. Such a model could be a useful adjunct of existing forecasting models of the Ontario economy.

(2) A data assembly effort to develop series on inter-provincial trade flows should be launched.

[13] This augmented version of TRACE has been developed for trend analysis by the Institute for Policy Analysis under a research contract with the Ontario Economic Council (see forthcoming study by Foot *et al.* 1977).

[14] Information regarding this model may be obtained from Data Resources of Canada.

[15] For a description of the basic structure of this model, see Jump (1972).

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Fiscal Dimensions of Provincial-Local Government Relations in Ontario

D.A.L. Auld

This paper discusses some of the arguments for and against local non-property taxes and conditional and unconditional grants. The author considers the main problem of local finance to be the unresponsiveness of property tax revenues to increases in income and public needs. He concludes that local sales and corporate income taxes are totally impractical while a local income tax is less so. He suggests increased unconditional grants to municipalities, indexed to reflect cost increases. Conditional grants to reflect spillovers of costs and benefits would also be required.

I. Introduction

The rapid growth in Canadian urban areas has generated a variety of problems for local government administrators and politicians. Of these, perhaps the most pressing is the question of how to finance the ever-expanding array of public goods and services required for the efficient operation of an urban area. There are two basic dimensions to this problem. First, what are the implications of altering the level and mix of local revenues (from own sources)? Second, how *do* and how *should* local governments and the province cope with the ever increasing complexity of provincial-local fiscal rela-

tions in terms of government? This paper concentrates on the former issue although it is obvious that the latter cannot be ignored.

The paper is divided into five sections. Section II is a description of the expenditure-revenue position of local governments in Canada and Ontario. The third section deals with the meaning and measurement of 'fiscal imbalance' and its relevance for Ontario local governments. The historical and present structural reasons for the extent of fiscal imbalance in Ontario local governments will be noted briefly. Section IV is concerned with the objections that Ontario municipalities have had against the provincial government's 'solution' to the fiscal imbalance. The strength and weakness of the arguments will be discussed and the rationale for provincial involvement noted as well. The fifth section explores alternative fiscal arrangements that have been suggested as ways of reducing or eliminating the gap between local spending and own-source revenues. Section VI presents our conclusions and summary.

II. The Fiscal Position of Local Government

As many sources will clearly reveal, the local public sector has been rapidly expanding over the past two decades, whether measured in absolute terms, as a percentage of GNP or in real expenditures per capita, and Ontario has been no exception to the general pattern (Auld, 1976). In fact much of the recent growth in expenditures on goods and services as contrasted to transfer payments to persons has been at the local level of government.

Precisely measuring the extent of this growth is difficult because of changes in the meaning of the data over time, but nevertheless the overall pattern clearly reveals substantial expansion. Since 1955, for example, local expenditure has risen from 5.8 to over 9 per cent of gross national product. What has happened, however, is that this expansion in spending has not been paralleled by revenues derived exclusively from local sources such as property taxation. To finance the expansion, a large share of the funding has come from provincial governments in the form of grants to local government (see Figure 1).

III. Fiscal Imbalance: The Basic Issue

Studies of local public finance in the United States have given rise to the term 'fiscal imbalance' to describe a shortfall of revenues necessary to cover expenditure in terms of the difference between the responsiveness of own

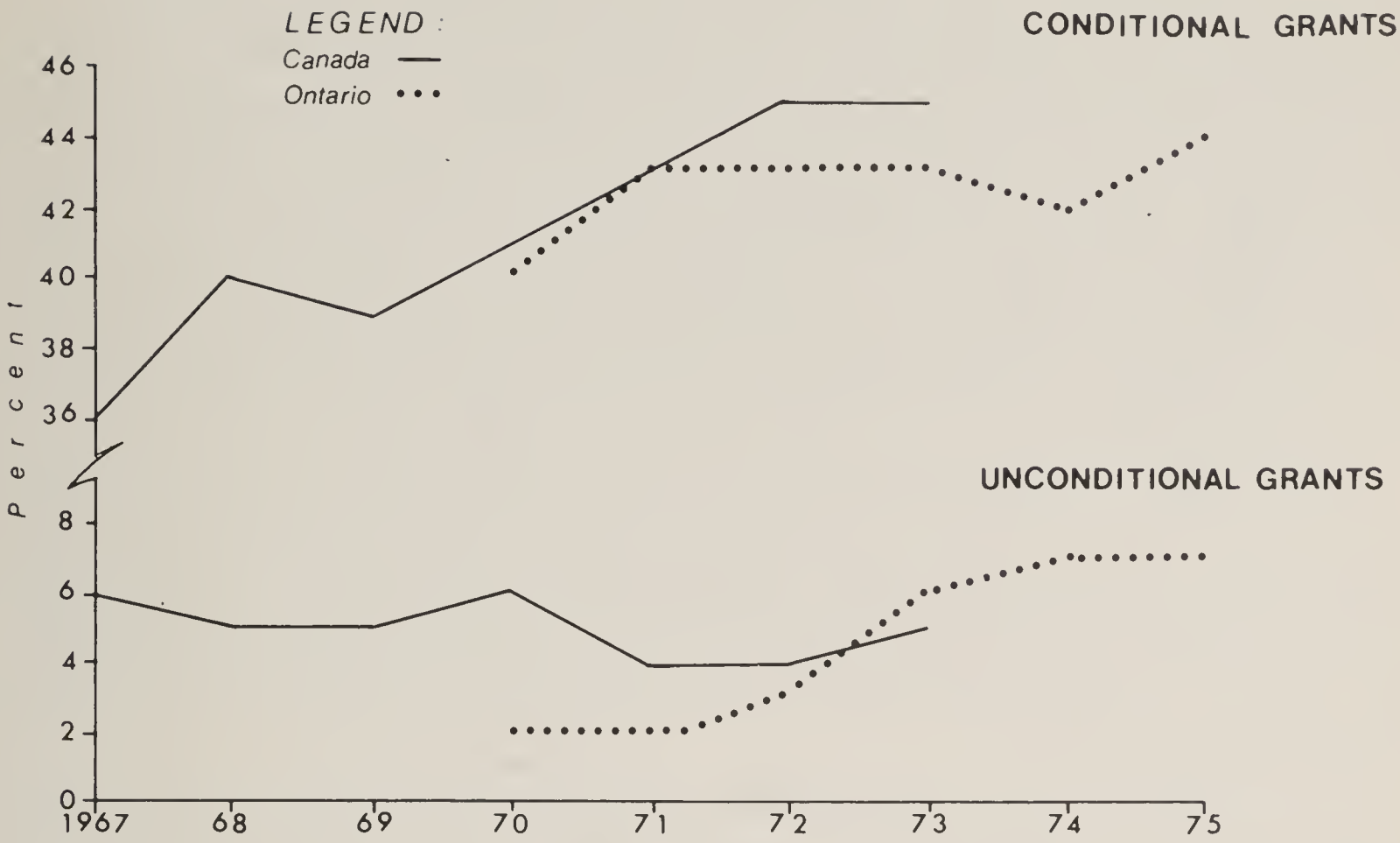

Fig.1 PROVINCIAL GRANTS TO LOCAL GOVERNMENTS AS A PERCENTAGE OF TOTAL LOCAL GOVERNMENT REVENUE

SOURCE: Statistics Canada, Municipal Government Finance (68-203) and Local Government Finance (68-213) (Ottawa: Queen's Printer); Government of Ontario, Ontario Budget, Selected Years; Financing Development of Local Government in Ontario, 1974

source revenue and expenditure to changes in income and wealth. Although there is some debate over the meaning of fiscal imbalance, it is basically the difference between local expenditure and local revenue (excluding debt) raised by the municipality.

The evidence for Canada and Ontario clearly shows that local fiscal imbalance has been offset largely by provincial conditional grants and by some debt financing, the former being at the heart of the provincial-local confrontation. The widening gap between revenues and expenditures is a direct result of certain basic historical facts and an inflexible revenue system at the local level.

The historical facts are well-known; urbanization, new technology and rising incomes have all contributed to increased demands for local goods and services. The Great Depression, which found municipalities with a large share of the responsibility for social welfare, placed impossible demands on local governments. With revenue derived largely from a tax based on property values which fell sharply local governments were soon bankrupt. This led to (i) extensive provincial intervention and (ii) in some provinces (Ontario) government control over debt issues at the local level. After the Second World War, the pressures on local government expenditure continued. These pressures came from several sources; most important were urbanization and

higher real incomes. The rapid migration to the cities led to the need to modernize transportation systems and expand road facilities. Higher incomes led to an increase in demand for recreational facilities, police and fire protection and an improved environment in which to live. Industrialization and technology influenced the pattern of demand for public services as society increasingly called upon government to intervene in the conflict between private and social objectives. Reluctant to raise property taxes and constrained from debt finance beyond a certain level, financial relief (at least in Ontario) had to come from the province. It came mainly in the form of conditional grants.

If we look at the evidence for the province of Ontario over recent years, grants have accounted for an increasing share of local revenue. Conditional grants have remained at roughly 43-44 per cent of total revenue while unconditional grants have increased from 2 to 7 per cent over the past five years. By 1974-75, roughly one half of local government revenue came from the provincial government.

The increase in unconditional grants during the past three or four years reflects not only changes in old unconditional grants but the introduction of new provincial-local fiscal arrangements. First, the main per capita grant has been increased to reflect the rising cost of local service provision. Second, a resource equalization grant has been added to the array of fiscal arrangements which sets out to partly close wealth differentials, wealth being defined in terms of per capita property value assessment. Third, there is also a general support grant which,

> ". . .recognized the inability of property tax revenues to keep pace with the rapidly increasing financial requirements of municipalities, notably in the face of higher rates of inflation." (White, 1974)

These grants along with increased conditional grants have permitted local governments to increase spending in the face of rising urban population and rising costs, without having to increase property tax rates to exorbitant levels. These changes have in part been made in response to the requests of local governments but they have not done much to quench the thirst of local government officials for major provincial-local financial reform.

IV. Political Dimensions of the Problem

(A) LOCAL GOVERNMENT VIEW

Until very recently, fiscal imbalance was, as shown above, accommodated by a combination of conditional grants (based on a set of conditions and a cost sharing formula) and unconditional grants, based partly on population and partly at the discretion of the provincial government. Increased reliance

on conditional and to a lesser extent discretionary conditional grants has been vehemently opposed by local governments for a variety of reasons. The following statement is a succinct interpretation of local government sentiment.

> "As the fiscal plight of local government worsened, the federal and provincial governments responded through financial grants-in-aid and shared-cost programs. While the assistance was welcome, it provided only a series of ad-hoc, short-run solutions. . .the benefits of financial assistance. . .were offset by the associated costs of diminishing policy-making responsibilities. . .Local institutions face the threat of becoming less and less relevant." (Canadian Federation of Mayors and Municipalities, 1973)

One of the basic complaints of local officials is that to obtain conditional grants, they must account to Toronto for their expenditure, not to their constituents. If government is designed to seek out and interpret the needs of society, having to account to another level of government weakens the process of expenditure responsibility. The views held by the provincial legislature regarding what should be spent locally and in what magnitudes may not reflect the wishes of the local electorate. Widespread compromise rather than local priority becomes the basis for programs involving grants-in-aid.

If it is argued that community decisions should be based upon the desires generated within the local community, then transfers of monies without power leads to a deterioration in that network. Local governments who should be concerned with the establishment of priorities in their jurisdiction find that in order to obtain funds to achieve their objectives they must alter their priorities. They may no longer coincide with local objectives. The characteristics of the programs take on a provincially dictated flavour, not a local one.

In addition to having to tailor a significant proportion of expenditure to fit expenditure priorities imposed by the provincial conditional grants, local councils face uncertainty as to the duration and conditions of the program. Coupled with uncertainty from year to year as to some parts of the unconditional grant money, it becomes extremely difficult for local government to undertake any long range expenditure planning. A third component of uncertainty is the amount of permissible debt the province will allow a municipality. This can constrain local governments from undertaking capital-orientated public works in anticipation of growth. Such advance construction sometimes makes more sense than having to undertake these expenditures when growth has actually taken place.

Local government officials have argued that conditional grants should be of two types; conditional mandatory and conditional permissive. The first category refer to grants to be used to *guarantee* that local governments do undertake to provide certain goods and services that the Ontario government deems absolutely essential. Such grants would cover 100 per cent of the

program's cost with the local government assuming the responsibility of administering the program. The second category, conditional permissive, are basically stimulation grants except that they should be orientated towards broad policy areas (transportation) rather than specific programs (bus subsidies). All that would be necessary for approval of funds would be evidence of local projects in the broad area defined by the grant program. These 'block fund' grants would allow provincial budgetary control and at the same time permit separate local jurisdictions to respond to the wishes of their electorate through the development of projects filling their needs.

It was noted earlier that some development in the area of equalization payments had begun in recent years. There is a strong feeling at the local level that equalization grants should be a fundamental part of provincial-local fiscal arrangements. The major complaint at present is what the municipalities believe is a rather crude method of assessment that is the base for the equalization payments. Some local governments would like to see the basis for the payments described in terms of regional councils with the allocation of the total sum to separate local councils made at the regional/county level. The rationale for such an encouragement is that some services are provided at a regional/county level; the more important these become, the more essential the need for equalization at that level of government.

(B) RATIONALE FOR CONDITIONAL GRANTS

There has been a good deal of political rhetoric in the recent attacks by local governments against the system of conditional grants and to a lesser extent, that of unconditional grants. Is it just a drive for more money? Are there genuine reasons why the provincial government should maintain considerable budgetary control (and project control) over local governments? This is a very difficult question since it leads to a discussion of the optimal assignment of expenditure/tax/borrowing functions in a federation. In the space permitted here it is impossible to do justice to the theoretical public finance literature in this area. The best that can be done is to mention some of the key considerations that are relevant.

First, at what level of government can a given public service be provided most efficiently (at the lowest cost)? Second, for any given expenditure within a political jurisdiction to what extent do the benefits of that program go beyond the boundaries of the jurisdiction financing and administering the program? Third, once a level of government has been selected to provide the service and the financing arrangements established, what is the relationship between those who receive the benefits and those who pay the costs? Finally, what is the case (if any) for one level of government imposing its 'values' on other levels of government? The argument between provincial and local governments appears to be clothed in the rhetoric one experiences at the federal-provincial or federal-state level in other federations. In some

instances it reduces to centralized versus decentralized federalism, the outcome depending largely on the participants at the various levels of government. The dimensions of the provincial-local debate are not that different from the federal-provincial level except that local governments have no constitutional standing in Canadian federalism.

The second consideration, that of benefit spillover, (or external benefits) is the most relevant for the discussion of provincial-local conditional grants. It has been argued that:

> ". . .where the ratio of external benefits to local benefits is large, the case for local autonomy and responsibility is weak. In these situations the level of service should be approximately uniform and consequently should be determined by a government above the municipality." (Johnson, 1969)

Operationally, such programs would be financed by the higher level government but the administration of the funds would be delegated to that level of government which could operate the program at the least cost. This type of arrangement is very similar to what local governments have referred to as conditional mandatory grants.

The opposite end of the spectrum contains those programs, the benefits from which are for the most part internal to a given jurisdiction. Such programs should therefore be financed and operated by that jurisdiction. Between the two extremes are programs or projects which generate some benefits internally and produce some spillovers. Ideally, any given jurisdiction should be encouraged, through stimulation grants (conditional grants of less than 100 per cent funding) to undertake expenditures up to the point where social benefits and costs at the margin are equated. Practically, however, there is an almost insurmountable difficulty in determining all those local expenditures which generate significant spillovers and the extent of the spillovers. It may well be that non-education conditional grants (those for recreation, roads, social welfare) are of an appropriate magnitude to cover the extent of the spillovers. This argument, however, has not been pursued with dedication by any of the groups involved in settling the matter of fiscal imbalance. All we can say is that *some* conditional grants are justified in this way. The problem at the moment may very well be that the wrong programs are covered by conditional grants and hence this distorts the allocation of resources and the appropriate degree of accountability for the program.

Regardless of how much conditional grant financing is justified on purely economic grounds, there seems to be good cause for concern over the basic structure of such programs and good reason to seriously consider a broader approach to stimulation grants. It is obvious that detailed financial accountability by local governments for the dollars they spend causes administrative expense and an undesirable adherence to provincial values for spending that has a significant local content.

V. Solutions to the Problem

There have been numerous proposals designed to re-align the streams of expenditure and revenue more closely to what local governments feel is appropriate. Provincial officials have also suggested schemes, some of which involve the federal government. The purpose of this discussion is to suggest those alternatives which may well be feasible and highlight the costs they involve.

(A) TAX SHARING

It has been suggested that local or regional governments impose their own income tax. Such a proposal has been rejected on the following grounds:

(1) the tax rate would have to be large to collect any significant revenue,
(2) it would be too costly to collect,
(3) it would cause people to change their location in response to tax rate differentials.

These arguments are not altogether substantiated by the evidence and in the light of modern tax collection methods. First, such a tax does not have to *replace* all property taxes and conditional grants; it could be directed toward reducing the increasing reliance on conditional grants and provide local government with more flexibility to initiate programs in response to local needs. If it is offset by an equal reduction in provincial and/or federal personal income taxes, there is no tax increase whatsoever. Second, personal income taxpayers are geographically coded and it would take little effort to calculate what the resident in Hamilton owes to the city given a 2 per cent personal income tax. Thirdly, migration would not occur if the tax rate was common to all localities and combined with a lower federal or provincial tax rate. Even if tax rate differentials did exist, there is no reason to suspect that residents would respond, in the aggregate, any differently than they do to property tax differentials.

The three major problems would appear to involve national stabilization objectives, geographic wealth differentials and long-range planning. A locally-established income tax rate discriminates in favour of high income localities; it would take a three per cent tax rate in Brantford to generate the same revenue as a 2 per cent rate in Oakville. This problem could be solved using a simple equalization grant formula if so desired. The stabilization problem arises if the share of personal tax rates set by local governments becomes so large as to thwart fiscal stabilization policy. It behooves the architects of such a scheme to place a limit on local tax rates. Finally, the potential (and actual) fluctuations in personal income, especially at the local level, could make long range planning rather difficult for those communities whose economic base is sensitive to the business cycle.

Location-specific taxes on corporations, retail sales, capital gains and

gifts are not feasible for a wide variety of reasons. Sales taxes in one area can be avoided by shopping in neighbouring municipalities where the tax is lower or non-existent. Even if the tax rate were common across localities, the administrative difficulties involved in collecting the revenue from all but local, non-chain outlets would be extremely costly. A corporation income tax would be extremely difficult to collect since firms do not necessarily calculate the profit earned in each plant that a firm may have. It is virtually impossible in multi-plant firms to assign total taxable profit to each municipality where business is done. In addition, frequent changes in tax rates in response to competition for industry would create a good deal of uncertainty and thus limit the usefulness of such a tax.

(B) REVENUE SHARING

The possibility of local governments sharing the proceeds of one or more taxes is much more appealing than tax sharing. Personal, corporate and sales tax revenue (singly or jointly) could well form a base from which annual per capita grants could be made. In such a scheme, the only advantage of one tax over another is the degree of flexibility of revenue from year to year. The sales and personal income tax could be made visible by stating that, for example, the sales tax is composed of 5 per cent for the provincial coffers and 2 per cent for local governments. Grants based on this scheme would grow with the economy (a major complaint of local governments has been lack of access to growth revenues) and the revenue would be 'automatic' unlike conditional and discretionary unconditional grants. Returning these funds to local governments on a per capita basis may provide an implicit redistribution.

The Ontario government has suggested a Tax Sharing Plan involving the federal government. It is misnamed in the sense that the Ontario government does not envisage an arrangement whereby the money collected would be returned to the geographic area that generated the tax base. The Ontario plan is a gradual transfer of 5 per cent of federal personal income tax revenue to the provinces with an 'automatic' flow through to local governments arranged by the province in question and its local governments. What the plan does not detail is the area of provincial support that would be reduced, eliminated or frozen as the shared tax revenues began to flow through to the local governments.

An alternative to revenue sharing as a means of reducing 'fiscal imbalance' is to increase the rate of taxation on property. Proponents of this scheme, however, feel that while this would provide a high degree of accountability, it should only be considered if and when substantial changes are made to the structure of the property tax. The problem with the latter is the lack of consensus with respect to what changes are most important. These issues, especially in terms of equity and efficiency, have been docu-

mented and unless a consensus can be reached on some basic structural changes, there seems little hope that increases in property taxation will be a politically acceptable substitute for conditional grants.

While tax sharing has its advantages in terms of providing a guaranteed, growth-based tax there are constitutional matters which may make it difficult to have the third tier of government directly involved in tax sharing. Since local governments have no constitutional status and are basically a creature of provincial governments, a growth-based per capita grant of an unconditional nature may be more feasible. An unconditional grant (in that it is not program-specific in any sense) could be structured to reflect population growth (the basis for the absolute cost of public services in a non-inflation world) and rising costs during periods of wage and price inflation. The components and structure of such a grant might be as follows.

The per capita grant in any year would be equal to the grant given the previous year and increased by a cost factor based on the percentage increase in the average wage (in the locality) over the previous year and the increased cost of materials. The latter component of the cost adjustment factor would likely have to be on a provincial or even national basis but the use of a local wage index would ensure that the local government could compete for its labour within the geographic area. The cost factor would essentially 'inflation-proof' the stream of revenue for local governments; and since the scheme does not tie the revenue to any one specific tax, the grant is, to some extent, recession proof. This is a distinct advantage over tax sharing where certain local jurisdictions are apt to suffer substantially in terms of revenue shortfalls during economic slowdown. It reduces uncertainty in planning, which is critical for many local government areas. Once population growth targets are established, the local governments can be ensured of sufficient real per capita resources to achieve their expenditure goals in concert with the preferences of the local constituents.

VI. Conclusion

The preceding sections would appear to highlight the following characteristics of provincial-local fiscal relations in Ontario.

(1) Local government expenditure has tended to out-run local own-source revenues.
(2) The resulting fiscal 'vacuum' has been filled by increasing conditional grants and, very recently, more unconditional grants.
(3) Local governments wish to have more control over their spending and are therefore opposed to the increasing reliance on conditional grants.

(4) Where conditional grants are necessary (justified on efficiency grounds) they should be broad-based.
(5) There are a number of alternative methods to reduce local fiscal imbalance.

Although there are probably as many alternative fiscal arrangements as there are policy advisors, a basic starting point might well be to consider what expenditures at the local level reflect 'spillovers' to other local and even provincial jurisdictions. These expenditures, or some proportion of these, would then be financed through conditional grants from the provincial and federal government. The remaining expenditures should then be financed by own source revenue or a revenue source that is unconditional and responsive both to economic and demographic growth. Finally, due consideration should be given to carefully defining what is current and what is capital expenditure to ensure the proper mix of debt and tax revenue finance.

The problems with this approach are (1) how to divide expenditures into those exhibiting substantial spillovers and those that do not; (2) what is capital expenditure; (3) what kind of unconditional transfers (if any) should be used to supplement own-source revenue. A fourth issue is that of economies of scale; at what price does one 'trade-off' local autonomy for the cost benefits that may be reaped by providing a public good or service at a higher level of government? The first question is critical because it is at the heart of the 'local autonomy' and 'fiscal accountability' arguments put forth by local government. Nevertheless, the above framework would appear to be a convenient starting point for negotiations as to the settlement of the differences between provincial and local government officials.

Finally, there is the fiscal philosophy of 'collective' or 'public' interest, which cuts through all arguments dealing with spillovers and economies of scale and declares that all citizens of a province have a right to similar services wherever they may reside. The question of a 'collective interest' approach to expenditure on certain local goods and services has recently received special attention in the United States where it is argued by some that in certain areas of expenditure, primarily schools, the goal should be one of "categorical equity". Categorical equity requires that for specific areas of expenditure, the per capita real consumption should not vary across a province (state) or even across the nation. If there is variation, it should in no way be related to wealth differentials among local (state or province) jurisdictions. This latter condition has been referred to as "wealth neutrality". (Feldstein, 1975).

At first glance, this may suggest that the upper level government, to achieve wealth neutrality, would have to assume responsibility for those goods and services where categorical equity is desired. An alternative suggested approach however would allow local responsibility through the granting of a cost-sharing conditional grant that would match expenditure at a

higher rate in less wealthy communities. The major problem underlying such a scheme is the operational definition of wealth. If this can be agreed upon, such a scheme may be well worth exploring since it would meet the province's present equalization objectives and the local government's desire for local responsibility and broad-based conditional grants.

Although there is considerable debate between local government officials and the province on the topic of fiscal arrangements, there appears to be little concern about the financing arrangements and expenditure responsibilities at the 'grass roots' level. It is not an issue, in most cities, during municipal elections nor does it emerge as a major platform in provincial elections. Nevertheless, the issue is implicitly raised whenever local governments have to decide how to best reflect the wishes of the electorate and how to pay for what they spend. In the end, the basic objective is to design a set of fiscal arrangements that ensure growth of revenue and efficient cost-sharing programs while minimizing inequities among communities. Although an ideal system is not likely attainable, there is room for definite improvement in the present arrangements.

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Financing Local Government

Geoffrey Young

This paper deals with the same topics as the preceding paper, but reaches some different conclusions. This paper argues that the frequent mention of the inelasticity of the property tax should be recognized as primarily an argument in favour of politically painless taxation. The paper suggests that unconditional provincial grants to municipalities have the disadvantages of separating taxing and spending powers and of failing to encourage municipal policies that have important benefits outside the municipality. Other possible sources of revenue are suggested.

In financial terms, the relationship between a province and its municipalities is much like the relationship between the federal government and the provinces. (Constitutionally, the relationship is fundamentally different, for the municipalities have only the powers the province gives them.) Like the federal government in dealing with the provinces, the province in dealing with its municipalities can be seen as facing two tasks. First, it may be argued, the provincial government should reduce inequalities in tax rates and in the quantity and quality of basic public services provided by local government, to the extent that these inequalities result from differing ability to raise taxes (that is, from differences in average taxable wealth of residents). It should do this while reducing the strength and independence of local

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government as little as possible. Second, the provincial government should prevent local governments from adopting policies that would benefit their own residents at the expense of other residents of the province.

The provincial government can use several varieties of grants and tax arrangements to achieve these goals. This paper examines some of the arguments for and against various ways of financing local government spending.

Equalization

Equalization of tax rates and spending power among municipalities is presumably as desirable an objective on political grounds as is equalization among provinces. The economist is no more qualified than others to make judgements about equity. In addition to fairness, however, there are also arguments for equalization that are based on economic efficiency.

One might suspect municipal equalization is more important to economic efficiency than is equalization among the provinces, simply because people are more likely to move between municipalities in response to tax and public spending incentives than between provinces. In either case, movement in response to tax incentives need not be socially desirable. Areas that can offer attractive tax rates because they happen to possess a rich property tax base or (in the case of provinces) natural resource revenues need not be the same areas where natural amenities or opportunities for employment are most attractive (Buchanan and Wagner, 1970). Failure to equalize municipal revenues with either grants or the provincial assumption of responsibility for some part of municipal spending programs can result in a vicious circle that is common in U.S. cities. Property tax rates that are lower in middle-class suburbs than in poorer central cities encourage a flight to the suburbs by those central city residents and businesses that can afford to move. The result is even greater property tax rate disparities and a further decline in the central cities; a decline that has been blamed, at least in part, on the system of taxation and the location of municipal boundaries (Rothenberg, 1970). This problem is less serious in Canada precisely because provincial policies have usually resulted in equalization among municipalities, either by means of grants or provincial assumption of some programs.

A related problem, perhaps more serious in Canada, is that of municipalities that discourage, by means of zoning and approval delays, the construction of low-cost housing. While such reasons for exclusion as maintaining "neighbourhood character", the need for parkland, or the inadequacy of services are often stated, a more likely reason is that property tax revenues from such housing are often expected to be less than the costs of providing services, so that new development will mean higher taxes for existing resi-

dents. This problem is reduced when in-migrants to low cost housing bring with them an entitlement to larger provincial equalizing grants.

The question of the amount of inter-municipal equalization a provincial government should undertake is, as we have suggested, only partly amenable to economic analysis. It may be useful, however, to examine the most complete form of equalization likely to be used. Under *full* (or *power*) equalization, a provincial grant is added to every municipality's tax proceeds so that each receives equal per capita revenue for each percentage point of taxation it levies on its (market value) assessed property tax base. Looking at it another way, full equalization grants result in tax rates in each municipality that directly reflect the level of per capita spending, not the wealth of the per capita tax base. With less equalization, poorer municipalities must either set a higher tax rate than wealthier ones or spend less per capita on services.

Full equalization is attractive in many ways. Only with this degree of equalization will an individual with a given value of taxable property find rich and poor municipalities equally attractive in terms of the taxes he pays and the quality and quantity of public services available. Only with full equalization will a municipality find a new arrival who builds a small cheap house (and thus pays low taxes) just as desirable as one who builds an expensive house (and thus pays high taxes) if providing either with services costs the same. Full equalization thus eliminates the financial incentive for individuals to build in wealthy municipalities to obtain the benefit of their low tax rates, and the financial incentive for wealthy municipalities to exclude low-cost housing.[1] It may thus help achieve more economically efficient development in cities composed of several municipalities. Full equalization is also intuitively appealing in that it seems "fair". It has several serious drawbacks, however:

(1) A full equalization grant can be looked at as a cost-sharing grant for all municipal expenditure at a rate that varies inversely with the tax base of the municipality. Economic analysis of grants in the United States (Feldstein 1975, Ladd 1975) suggests that full equalization overcompensates for wealth differences, in the sense that when poorer municipalities receive such grants they end up spending *more* than municipalities with larger per capita tax bases. In this sense full equalization goes too far in making up for wealth differences.

(2) Full equalization implicitly accepts the property tax rate as a measure of "tax effort", i.e. of the sacrifice involved in paying one's taxes. In fact, however, the ownership or rental of real property is a most imperfect indicator of ability to pay, which also depends on income and other factors.

(3) There are good arguments based on economic efficiency for

[1] Capitalization of taxes into property values may under some conditions offset the incentives to movement that result from tax rate differences. Full capitalization may not occur, however. Unlimited amounts of land may be available at the value for agricultural use, for example.

financing many urban services by means of user charges rather than by general property taxation (see, for example, readings in Mushkin 1972, Downing 1976). If each resident pays a charge equal to the service costs he imposes on the municipality, it makes no difference to him whether he lives in a rich or a poor municipality. To the extent such charges are practical and acceptable (most people would consider them unsuitable for services such as education) equalization is not required. Indeed, the existence of an equalization program may make poorer municipalities less willing to introduce such charges, which would result in lower tax rates and a smaller equalization grant.

(4) While full equalization does have the important advantage of removing some of the financial penalty that municipalities suffer when they admit new housing of low taxable value, it also removes the financial benefit from admitting commercial or industrial property, because the additional taxes collected are completely offset by lower grants. If such developments, though desirable from the standpoint of the province as a whole, are considered locally undesirable because of the traffic or unsightliness they create they may have difficulty finding a place to locate.

The above discussion suggests the conclusion that there is no perfect equalization scheme. Full equalization has some appeal from the points of view of equity and economic efficiency, but also has disadvantages from both points of view. Certainly some compromise formula, perhaps including both unconditional grants and general cost-sharing grants at rates that vary with the tax base of the municipality, could be developed[2], but it too would be open to criticism. In short, it should be recognized that no equalization program can be either consistent with economic efficiency in every sense or with every reasonable standard of equity. The characteristics and consequences of any proposed equalization program may not be immediately apparent and should be carefully examined.

Conditional Grants

A conditional grant requires that the municipality spend some amount, usually more than the amount of the grant, on a specified program. The same arguments that can be made for and against federal-provincial conditional grants (see the paper by Young elsewhere in this volume) can also be applied to provincial-municipal conditional grants. Municipalities, like the provinces, have objected vigorously to the interference with their expenditure priorities that necessarily accompanies conditional grants. Conditional

[2]Feldstein (1975) suggests a formula for school grants using the second of these elements, cost-sharing grants at varying rates.

grants for municipalities can, however, probably be defended more easily than those for provinces. Spillovers of costs and benefits between municipalities, the most acceptable reason for conditional grants, are likely to be proportionately larger than those between provinces, simply because municipalities are smaller and closer together than provinces. Expenditures by a municipality on roads and road maintenance, policing, parks, public transportation and many other services have important effects on neighbouring municipalities. Taxes may also spill over into neighbouring municipalities; property taxes on commercial and industrial property may be passed on by the owners to customers and employees, many of whom may live outside the municipality, in the form of higher prices or lower wages. This situation is undoubtedly less common between provinces. Both tax and expenditure spillovers can to some extent be offset by provincial cost-sharing grants. An alternative that may sometimes be preferable is to assign programs to metropolitan governments embracing several municipalities, or to the province, when externalities can thereby be reduced.

Conditional grants may help to correct divergences between local interests and what are perceived as the interests of the province at large. For example, they provide another approach to the problem posed by the frequently hostile attitude of local government to low-cost housing, an attitude based partly on prejudice and partly on a rational response to the local costs and tax revenues expected to result from such housing. Most of the same people who reject low-cost housing (whether subsidized or not) in their neighbourhood or municipality would agree that the young and the poor should not be left homeless. If the province is unwilling to impose socially desirable types of development on reluctant municipalities, it can overcome their hostility with grants conditional on new development of the type considered most favourable to the people of the province as a whole.

Some existing conditional grants are hard to justify on the basis of benefit spillovers. The present federal and provincial assistance programs for sewer systems are examples of conditional grants to which the wrong conditions are attached. The federal program pays two-thirds of the cost of sewer trunk lines and treatment plants irrespective of the number of dwellings being served. The provincial program for replacing (for health reasons) individual wells and septic tanks with water and sewer pipelines provides a grant that increases directly with the cost of servicing in order to keep annual charges per dwelling within a specified range. Although not their purpose, the effect of both these programs is to reduce the financial incentive for development that can be cheaply serviced; that is, usually high-density, and probably low-cost, housing.[3]

[3]Several studies (e.g. Pearson 1967, Real Estate Research Corporation 1974) have shown that the costs of providing public road, sewer, water and other services decrease (per household) as lots become smaller.

Unconditional Grants and Tax Sharing

Over the past few years local government expenditures have been increasing faster than local tax revenues. This so-called "fiscal imbalance", which has been filled by conditional and unconditional grants from provincial governments, has been a source of worry to local governments. The various possible means of dealing with this perceived problem deserve some comment.

Local governments are likely to see the disparity between their spending and their tax revenues as a problem resulting from the relatively low "income elasticity" of property tax revenues. In other words, as the economy grows, property tax revenues from a given tax or "mill" rate grow more slowly than do revenues from the income tax, which increase more than in proportion to total income, without rate increases, as taxpayers are pushed into higher tax brackets. Property tax revenues also grow more slowly than those perceived public needs falling under local jurisdiction (White, 1974). Local governments have therefore pressed for a share of the more "elastic" (fast-growing) tax sources such as the income tax.

There are several ways the province could share income tax revenues with the municipalities. The different methods have very different consequences.

Simply allowing the municipalities to impose their own income taxes would create enormous administrative costs. Only the largest cities could contemplate undertaking such a tax program. Even if the provincial or federal government were to collect the tax, difficulties would undoubtedly arise over assignment of the tax base. For example, would an individual pay tax to the municipality where he lived, or where he worked? For corporations and businesses with several establishments problems would be even more severe.

A local income tax system could be greatly simplified by imposing the tax at a uniform rate collected by the province. Tax revenues would then be distributed back to the areas where the taxes were collected (a process that would require some negotiation) or else according to population or needs. This simplification defeats the major purpose of local taxation, however, for if local governments lose the power to set their own tax rates they have essentially lost responsibility for taxation. They cannot balance the benefits of expenditure against the costs of taxes. Distribution of the revenues would essentially be equivalent merely to a distribution of unconditional grants.

Such unconditional grants based on income tax collections may be precisely what many local governments would prefer. The primary advantage local governments see in the tying of unconditional grants to the proceeds of an "elastic" tax that grows more quickly than income is of course that they are guaranteed a source of funds, beyond provincial government control, that grows more rapidly than their own property tax base. The advan-

tages from a provincial view of this course of action are questionable, however. It is true that a property tax at a fixed rate does not normally produce revenues that grow as rapidly as those produced by even an indexed progressive income tax.[4] It does not necessarily follow, however, that the provincial government, with its access to elastic personal and corporate income tax revenues, must therefore transfer increasing sums to local governments. This proposition would be true if (i) it were felt that existing tax *rates* should be maintained even though the relative amounts collected from different bases were to change; or (ii) the judgement were made that income should bear an ever-larger fraction of the total weight of taxation; or (iii) the share of local government expenditure relative to total government expenditure were rising.

Argument (i), which seems often implicitly to underlie local government requests for further grants, should be recognized as primarily a plea for additional revenues without political cost. If local government spending increases relative to the total Gross National Product, the share of the burden to be borne by the various taxes should surely be a matter for careful examination. It should not shift merely because income tax collections as a proportion of G.N.P. increase without government action while increases in property tax revenues relative to G.N.P. require increases in rates (assuming assessed property values grow no faster than G.N.P.)

Argument (ii) is sometimes taken as self-evident, as if it were clear that complete reliance on the income taxes would be desirable and that other taxes are merely historical relics or theoretically unjustifiable levies retained for their revenue production. Even if other taxes were markedly inferior to the income tax, however, there would be advantages to a tax *system* that did not place excessive reliance on any one tax. As income tax rates rise higher and higher, problems of destruction of incentives, illegal evasion and legal avoidance become more serious. In fact most economists now accept the proposition that the property tax, viewed as a general levy on capital, is not necessarily regressive (Netzer 1973, Gaffney 1971). The advantages of that part of the property tax falling on the value of land – that it cannot reduce the amount of land in existence (in the way that a tax on buildings reduces the incentive to build), that it encourages the full use of land, and that it allows all citizens to share in the fruits of a natural resource – have been widely understood at least since Henry George wrote *Progress and Poverty* in 1879 (see section 3 of the paper by Scott in this volume). George advocated a land tax at rates high enough to collect most of the rental value of land.

[4]The view generally accepted by municipal governments is that property taxes "lag notoriously in their response to economic growth" (Canadian Federation of Mayors and Municipalities, 1970, quoted by Plunkett, 1976, 315). The low apparent elasticity of the property tax may be largely the result of assessment practices and the unpopularity of the tax, however. Clayton (1961, 139) estimates that over long periods (e.g. 1937-61) market property values in Ontario grew faster than personal income (although assessed values grew more slowly). Thus a property tax on true market values might actually have produced faster growing revenues than an income tax.

His writings gave birth to a widespread movement to introduce such taxes; it is only more recently that taxes on land have been popularly stigmatized as unprogressive.

The hardship wrought by the property tax on old people with large amounts of real property relative to their current money income is often seen as a shortcoming of the tax. Rather than reducing rates or exempting the residences of the aged, arrangements could be provided to allow elderly people to defer tax payments until their deaths, when accumulated taxes would be paid out of proceeds from the sale or re-mortgaging of the dwelling. Elimination of property taxes for the elderly may merely confer a benefit on their heirs.

Argument (iii), citing an increase in the expenditures of local governments relative to those of other levels of government, might indeed justify ever-growing grants to municipalities (as a proportion of their expenditure) for without such grants the size of collections from the tax base available to municipalities would have to increase relative to other taxes. It is true that from the early 1950's until about 1965 the share of local government in total government spending in Canada rose steadily (although it never approached the proportion attained before World War II). But since then the share of total government expenditures in Canada accounted for by local governments has declined from 27 per cent in 1965 to 22 per cent in 1974. (Figures are from the *National Finances 1975-76*, Table 2-11, and exclude hospital expenditure. Although local spending has indeed grown as a percentage of national income, provincial government spending has grown more rapidly still.) Thus although municipalities may have to raise property tax rates to meet expenditure increases, they are not faced with the necessity of increasing property taxes *as a proportion of the total tax burden* borne by Canadians.

In summary, the arguments for unconditional grants to municipalities tied to some elastic provincial revenue source are open to dispute.

The major argument against unconditional grants is the same as the argument against such grants from the federal government to the provinces. They destroy the link between taxation and expenditure which many think essential for true responsible government. Although the proposition that a government should be responsible for raising the money it spends cannot be proven,[5] it has long been accepted. The quotation from Laurier heading the paper by D. R. Huggett elsewhere in the volume expresses the view succinctly. Under this general argument, grants to municipalities should consist of

[5]Economists have, of course, developed models demonstrating that under certain very restrictive conditions the best level of expenditure on public goods can be determined. One of the conditions is that individuals directly pay the taxes from which public goods are provided. Such models are highly abstract, however. See any public finance text, for example Musgrave (1959) 74-78, Due and Friedlaender (1973) 49-52.

equalization grants to poorer areas plus those conditional grants required to ensure that municipalities act in the interests of the province rather than in their own narrow interests, where the two differ.

New Tax Sources

As alternatives to unconditional grants from the provincial government and increases in general property tax rates, there are at least two unexploited revenue sources open to municipalities. The use of either would serve to improve the quality of urban life as well as to raise revenue.

INCREASES IN LAND VALUE

Urban land value is created by the activities of both city government and private businesses and individuals. The former provides sewer and water services, fire protection, roads and public transportation facilities; the latter provide the customers, jobs, skills and labour and business services that make locations in the city desirable. Yet the benefit of increases in urban land value is often reaped by land owners and speculators who have contributed little to the city, perhaps holding land idle for long periods or using it below its potential. Federal and provincial governments, by taxing land holders through the corporation tax and capital gains tax, also gain a share of increases in land value. The municipal governments, with a more defensible right to the benefit than most other groups (as providers of services and as agents for local residents and businesses who create land value) gain only the smaller increases in revenues that result from growth in the size of the property tax base.

It is *increases* in land value, rather than high but constant land values, that constitute the richest potential base for taxation, however. Any unanticipated increase in the general land tax rate has the disadvantage that it tends to reduce the value of land and therefore may inflict capital losses on recent purchasers. Such retroactive capital gains taxation is usually considered undesirable. Taxation of increases in land value after a given starting date does not have this disadvantage. Not only does the present property tax not single out recent increases in land values, but delays in reassessment may mean comparatively low taxes for land that has recently enjoyed a jump in relative value.

One method of taxing increases in land value is simply to set a higher tax rate for any increase in land value accruing since the previous assessment, after allowing for inflation. Thus if a lot worth $25,000 in 1976 jumps to $50,000 by 1978 because of the announcement of a new subway line,[6]

[6]Stern and Ayres (1971) conclude that "benefits due to an improvement (in transportation) are capitalized almost exclusively into land values along the way, unless user costs (fares) or land taxes are raised concomitantly". They perform some calculations of the size of the effect.

freeway or department store, or the elimination of rent controls, the 1978 tax bill might be 3 percent ("30 mills") on the first $30,250 ($25,000 plus 10 percent per year for inflation) plus 60 mills on the remaining $19,750 of value. The very fact that there is a higher rate on increases in value will keep such increases lower than they would otherwise be, of course; with a straight tax of say, 32 mills (a general rate would have to be higher to raise the same revenue as the two-part rate) the value of the property might have increased to $55,000 because lower taxes would make it more desirable. In effect the municipal government is appropriating part of the capital gain that would otherwise go to the landowner and perhaps to the provincial and federal governments.[7] The primary difficulty with this system is that it would require high standards of land value assessment.[8]

Present-day municipal governments often restrict land uses by zoning or by imposing delays, expense and uncertainty in obtaining development permission. Such actions of course keep land values below the level they would reach in a free market and thus reduce property tax collections, under either the present system or the land-value-increment system outlined above. These restrictive actions of local governments may well improve the quality of city life, but if so, city residents, not taxpayers in the rest of the province, should pay for them. For example, land around a new subway station normally increases in value because its convenient location makes it suitable for stores, offices, and high-rise apartments. If the city can gain some of this increase either by the method we have suggested, by buying the land before the subway is announced, or simply by collecting higher property taxes on the increased assessment on the land (assuming the buildings would be built somewhere else in the city in the absence of the subway) then the revenue can be used to help pay for the subway. If city planners decide that it is more desirable instead to preserve existing low-density neighbourhoods by means of restrictive zoning, of course property values will not rise as rapidly. In this case, however, it seems unreasonable for the city to ask for provincial capital or operating grants or equalization payments to make up the difference. The taxpayers of North Bay or Ottawa receive little benefit from subways in Toronto, but surely less benefit still from whatever quality of neighbourhood life is preserved by development restrictions.

The existing network of restrictions on many kinds of urban development does have the advantage of providing municipalities with an alternative means of collecting a share of increases in land values. By levying substantial direct "impost" or building permit fees on new development approvals the

[7]Some municipal investments might cause some land values to fall (e.g. land next to an elevated railway). The system suggested here could help compensate landowners by allowing them to subtract 60 mills per dollar of decline in value from their tax bill.

[8]The property tax is often criticized on the grounds that it is badly administered. If as much (in proportion to revenues) were spent assessing property and administering the property tax as is spent collecting the income taxes (including private expenditures of time and money on bookkeeping, form-filling and arranging affairs to minimize taxes) this criticism would surely disappear.

city can appropriate a share of any windfall profit. An advantage to property developers is that it provides local governments with an incentive for speedy and certain project approval. Much potential profit now is effectively taxed by the city in non-money forms; delivery of other parcels of land for parks and schools, preservation of historic buildings, provision of sidewalks and underground wiring (for residential development) and changes in design to satisfy the aesthetic preferences of city planners. But much is lost forever in the loss of time waiting for approval, the expense of the process, and above all in uncertainty, which drives developers to more receptive areas and ensures that only projects expecting profits far above normal levels are ever undertaken.

The ability to gain a share of what are often seen as excessive profits to successful land speculators (those who are lucky enough to obtain project approval) may provide an incentive for municipal governments to make the approval process speedier and less capricious. It may also make it more democratic. The people who would live, shop or work in proposed new developments cannot be assembled to sign petitions and may not even live in the city. The effect on the price of land of their demands is their only voice in determining the use of the land. If the city government cannot levy high taxes on a piece of newly-desirable land, or has no need to, its decision on the use of the land may not represent the best interests of the people of the province as a whole.

FEES FOR USE OF ROADS

Another potential future source of revenue is provided by automobile use. Automobile users who travel at peak travel times in crowded cities do not begin to pay the true costs they impose on others. These costs are measured in terms of the land and resources devoted to extra road capacity (much of which is fully used for only an hour or two each day) and the delays imposed by each driver on other road users. There now exists a rather complex technology (using meters in cars triggered by roadside emitters that impose higher charges when roads are most crowded) for charging road users the extra costs their travel imposes on others (Ochs 1974, Elliott 1975). Though it is perhaps not yet practical such a scheme could some day offer substantial savings in the costs of roadbuilding by spreading demand over the day. It would also produce revenue for municipalities.

Until sophisticated methods become practical, cities might ration road use and raise revenue by such measures as a tax on all-day downtown parking.[9] A share of the gasoline tax would compensate city governments for the part of expenditures on police, traffic control, road repair and snow clearance made necessary by private automobiles. Automobile owners

[9]See, for example, Segelhorst and Kirkus (1973), who examine the effect of free and subsidized parking in discouraging the use of public transit in Los Angeles.

parking their cars on public roads could be made to pay for the privilege, especially when space is so scarce it must be rationed out to local residents by means of permits.

Conclusion

This paper has suggested that Ontario municipalities may exaggerate their difficulties in raising revenue and that there are disadvantages to the straightforward solution of the province simply paying out ever-higher unconditional grants. Equalization grants from the provincial government are desirable, however, as are conditional grants to encourage spending on municipal programs that have beneficial spillovers outside the spending municipality.

The often acrimonious debate over the future of our cities cannot be separated from the problem of financing municipal government. If municipalities could tax away part of the gains to land development they would have greater incentive to speed the process of development approval. If they could charge more for the use of expensive city roads now provided almost free to users, they might make decisions about transportation investments more rationally. Either innovation could also provide them with a new source of revenue.

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Contributors

D.A.L. Auld *is Professor of Economics, University of Guelph, and Associate Editor of* Canadian Public Policy.

Donald R. Huggett, B.A., B.Comm., C.A. *is a partner of the accounting firm of Coopers and Lybrand, Montreal.*

Anthony Scott *is Professor, Department of Economics, University of British Columbia.*

Carl S. Shoup *is Professor Emeritus of Economics, Columbia University. He is currently consultant to the Carnegie Center for Transnational Studies, New York.*

Richard Simeon *is Director, Institute of Intergovernmental Relations, and Associate Professor of Political Studies, Queen's University.*

Michael J. Trebilcock *is a Professor at the Faculty of Law, University of Toronto and Director of the Law & Economics Programme at the Faculty of Law.* J. Robert S. Prichard *is an Assistant Professor at the Faculty of Law, University of Toronto.* Gordon E. Kaiser *is a Visiting Professor of Law and Economics at the Faculty of Law, University of Toronto.* John Findlay *and* Peter Shiroky *are second year students at the Faculty of Law.* Charles Taylor *is a doctoral candidate in the Department of Political Economy, University of Toronto.*

Geoffrey Young *is a Research Officer, Ontario Economic Council.*

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